Supreme Court, U.S.
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No. 94-

IN THE
Supreme Court of the United States
OCTOBER TERM, 1994

CENTURY-NATIONAL INSURANCE COMPANY, *et al.*,
Petitioners,

v.

JOHN GARAMENDI,
Insurance Commissioner of California, *et al.*,
Respondents.

Petition for a Writ of Certiorari to the Supreme Court of California

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PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the cost-of-capital standard of *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), establishes a constitutional minimum for non-confiscatory rate regulation of a firm's regulated business.

PARTIES TO THE PROCEEDING

The petitioners in this case are: Century-National Insurance Company; Farmers Insurance Exchange, Truck Insurance Exchange, Fire Insurance Exchange, and Mid-Century Insurance Company (the FARMERS group); Federal Insurance Company, Vigilant Insurance Company, Sea Insurance Company, Northwestern Pacific Indemnity Company, Sun Insurance Office Limited, Alliance Assurance Company, Ltd., and Pacific Indemnity Company (the FEDERAL group); AVEMCO Insurance Company, Eastern Aviation and Marine Insurance Company, and National Insurance Underwriters (the AVEMCO group); Charter Oak Fire Insurance Company, Travelers Indemnity Company, Travelers Indemnity Company of Rhode Island, Travelers Indemnity Company of America, Phoenix Insurance Company, Travelers Indemnity Company of Illinois, and Bankers & Shippers Insurance Company of New York (the TRAVELERS group); Great American Insurance Company, Stonewall Insurance Company, and Transport Insurance Company (the GREAT AMERICAN group); General Accident Insurance Company, Pennsylvania General Insurance Company, and Camden Fire Insurance Company (the GENERAL ACCIDENT group); Home Insurance Company, Home Indemnity Company, Home Insurance Company of Indiana, and City Insurance Company (the HOME group); Zurich Insurance Company, American Zurich Insurance Company, Zurich American Insurance Company of Illinois, Empire Fire & Marine Insurance Company, Universal Underwriters Insurance Company, and American Guarantee and Liability Company (the ZURICH group).

The other parties to the consolidated cases in the court below included John Garamendi, Insurance Commissioner of California, and Voter Revolt, as well as 20th Century Insurance Company and 21st Century Casualty Company, and State Farm Mutual Automobile Insurance Company, State Farm Fire and Casualty Company, and State Farm

General Insurance Company. The two just-mentioned groups of insurers are the petitioners in a separate petition from the judgment below.

The remaining parties in the court below were: Hartford Steam Boiler Inspection & Insurance Company, Houston General Insurance Company, Balboa Insurance Company, Meritplan Insurance Company, Newport Insurance Company, Farmers Home Mutual Insurance Company, Western Home Insurance Company, American Continental Insurance Company, Sterling Casualty Insurance Company, Topa Insurance Company, Highlands Insurance Company, Highlands Underwriters Insurance Company, American Bonding Company, Continental Insurance Company, Boston Old Colony Insurance Company, Fidelity & Casualty Company of Newark, New Jersey, Fidelity & Casualty Company of New York, Fireman's Insurance Co. of Newark, New Jersey, Glens Falls Insurance Company, Kansas City Fire & Marine Insurance Company, Mayflower Insurance Company, Ltd., Niagara Fire Insurance Company, Pacific Insurance Company, Allstate Insurance Company, Allstate Indemnity Company, Northbrook Property and Casualty Insurance Company, Northbrook Indemnity Company, Northbrook National Insurance Company, USAA Casualty Insurance Company, USAA General Indemnity Company, United Services Automobile Association, American Bankers Insurance Company of Florida, Sequola Insurance Company, National Chiropractic Mutual Insurance Company, Republic Mortgage Insurance Company, Old Republic Insurance Company, Heritage Indemnity Company, Montgomery Ward Insurance Company, Forum Insurance Company, Motors Insurance Corporation, MIC General Insurance Corporation, MIC Property & Casualty Insurance Corporation, CIM Insurance Corporation, National General Insurance Company, Preferred Risk Mutual Insurance Company, Mid-West Mutual Insurance Company, Government Employees Insurance Company, GEICO General Insurance Company, GEICO Indemnity Company, and Criterion Casualty Company.

RULE 29.1 STATEMENT

None of the petitioners has a subsidiary other than wholly owned ones. The parent companies of petitioners are as follows: the parent of Century-National is Kramer Wilson Company, Inc.; the parent of the FARMERS group of companies is Farmers Group, Inc., whose parent is B.A.T. Industries, p.l.c; the parent of the FEDERAL group of companies is CHUBB Corporation; the parent of the AVEMCO group of companies is AVEMCO Corporation; the parent of the TRAVELERS group of companies is The Travelers Inc.; the parent of the GREAT AMERICAN group of companies is American Financial Corp.; the parent of the GENERAL ACCIDENT group of companies is General Accident p.l.c.; the parent of the HOME group of companies is Home Holdings Inc.; and the parent of the ZURICH group of companies is Zurich Holding Company of America, Inc., whose parent is Zurich Insurance Company, Switzerland.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
PARTIES TO THE PROCEEDING	ii
RULE 29.1 STATEMENT	iv
TABLE OF AUTHORITIES	vi
OPINIONS BELOW	2
JURISDICTION	2
CONSTITUTIONAL, STATUTORY, AND REGULATORY PROVISIONS INVOLVED	2
STATEMENT	2
A. Proposition 103 and the *Calfarm* Decision	3
B. The Commissioner's Implementation of Proposition 103	4
C. This Litigation	5
D. The 1994 California Supreme Court Decision	7
REASONS FOR GRANTING THE PETITION	11
A. The *Hope* Cost-of-Capital Standard for Confiscatory Rate Regulation Is a Constitutional Minimum	13
B. Confiscatory Limits on Regulated Lines of Business Cannot Be Justified By Overall Enterprise Profits	20
CONCLUSION	23

TABLE OF AUTHORITIES

Cases Page

Alabama Power Co. v. Alabama Pub. Serv. Comm'n, 422 So. 2d 767 (Ala. 1982) 12
Baltimore & O.R.R. v. United States, 345 U.S. 146 (1953) 12, 21, 22
Calfarm Ins. Co. v. Deukmejian, 771 P.2d 1247 (Cal. 1989) ..... *passim*
Central Maine Power Co. v. PUC, 163 A.2d 762 (Me. 1960) 12
Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989) 13, 14, 18
FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944) ..... *passim*
FPC v. Natural Gas Pipeline Co., 315 U.S. 575 (1942) 8, 16, 17, 18
Guaranty Nat'l Ins. Co. v. Gates, 916 F.2d 508 (9th Cir. 1990) 11
Healy v. The Beer Institute, Inc., 491 U.S. 324 (1989) 13
In re Public Serv. Co. of New Hampshire, 547 A.2d 269 (N.H. 1988) 12
Jersey Cent. Power & Light Co. v. FERC, 810 F.2d 1168 (D.C. Cir. 1987) 9, 12, 17
Kansas Gas & Elec. Co. v. State Corp. Comm'n, 720 P.2d 1063 (Kan. 1986), *prob. jur. noted*, 479 U.S. 1082, *appeal dismissed*, 481 U.S. 1044, 483 U.S. 1036 (1987) 12
Lucas v. South Carolina Coastal Council, 112 S. Ct. 2886 (1992) 22
Market Street Ry. v. Railroad Comm'n, 324 U.S. 548 (1945) 8, 17, 18
Mountain States Tel. & Tel. Co. v. Department of Pub. Serv. Regulation, 624 P.2d 481 (Mont. 1981) 12
Norfolk & Western R.R. v. Conley, 236 U.S. 605 (1915) 21, 22
Northern Pacific R.R. v. North Dakota, 236 U.S. 585 (1915) 21
Ohio Edison Co. v. PUC, 589 N.E.2d 1292 (Ohio 1992) 12

TABLE OF AUTHORITIES—Continued

Page

Pennsylvania Elec. Co. v. Pennsylvania PUC, 502 A.2d 130 (Pa. 1985), *appeal dismissed*, 476 U.S. 1137 (1986) 12

Permian Basin Area Rate Cases, 390 U.S. 747 (1968) ..... *passim*

Smyth v. Ames, 169 U.S. 466 (1898) 13, 18

South Central Bell Tel. Co. v. Louisiana Pub. Serv. Comm'n, 594 So. 2d 357 (La. 1992) 12

Tennessee Gas Pipeline Co. v. FERC, 926 F.2d 1206 (D.C. Cir. 1991) 11

United Gas Pipe Line Co. v. FERC, 618 F.2d 1127 (5th Cir. 1980), *cert. denied*, 450 U.S. 911 (1981) 11

Washington Gas Light Co. v. Baker, 188 F.2d 11 (D.C. Cir. 1950), *cert. denied*, 340 U.S. 952 (1951) 17

Other Materials

28 U.S.C. § 1257 2

"Prop. 103 Rollback Orders," *Los Angeles Times*, Nov. 23, 1994 13

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Petition for a Writ of Certiorari to the Supreme Court of California

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PETITION FOR A WRIT OF CERTIORARI

Petitioners, who are numerous insurance companies doing business in California's insurance market, challenge the California Supreme Court's construction of the constitutional standards for confiscatory price regulation. Pursuant to an initiative enacted by the voters of California in 1988, which was modified by the California Supreme Court on confiscation grounds in 1989, the state Insurance Commissioner in 1991 and 1992 adopted a complex formula, incorporating generic industrywide determinations as to permitted rates of return, to establish the maximum rates that insurers were allowed to charge in various lines of insurance during the year ending November 1989. The result has been a series of orders providing for refunds of billions of dollars. In several consolidated suits, the California Supreme Court broadly upheld the Commissioner's approach as consistent with this Court's confiscation stand-

ards under the Takings Clause. Petitioners challenge the California Supreme Court's construction of those standards.

OPINIONS BELOW

The opinion of the California Supreme Court (Pet. App. 1a-135a) is reported at 8 Cal. 4th 216, 32 Cal. Rptr. 2d 807, and 878 P.2d 566.[1] The opinion of the Superior Court of California (Pet. App. 136a-213a) is not reported. The earlier opinion of the California Supreme Court is reported at 48 Cal. 3d 805, 258 Cal. Rptr. 161, and 771 P.2d 1247.

JURISDICTION

The judgment of the California Supreme Court (Pet. App. 1a) was entered on August 18, 1994. A timely petition for rehearing was denied on September 29, 1994. Pet. App. 214a. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257.

CONSTITUTIONAL, STATUTORY, AND REGULATORY PROVISIONS INVOLVED

The case involves the Takings Clause of the Fifth Amendment, which states: "nor shall private property be taken for public use without just compensation." The case also involves two state-law enactments: Proposition 103, a voter-enacted initiative that made changes in the California Insurance Code; and regulations issued by the California Insurance Commissioner. Pertinent portions of these provisions are set out at Pet. App. 375a-399a.

STATEMENT

Although rate regulation typically is imposed to restrain the exercise of market power by monopolistic firms, the

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[1] A separate petition for a writ of certiorari from this decision is being filed by several other insurance companies who were parties to the case in the California Supreme Court. *20th Century Ins. Co. v. Garamendi*, No. 94-—— (filed Dec. 23, 1994). Rather than reprint the voluminous materials, we rely on the appendix to that petition, hereafter cited as "Pet. App."

State of California has in this case imposed stringent rate limits, and ordered substantial rate rollbacks, on a market with approximately 700 competitors. *See* Commissioner's Br. in Cal. S. Ct. at 5. The regulations apply formula-based, generic, industrywide standards to all firms, regardless of differences in the actual returns needed to compensate investors for the particular risks that they assumed. Yet, while agreeing that the permitted rates must be judged by the constitutional standards for confiscation, the California Supreme Court concluded that the constitutional standards do not entitle a regulated firm to earn its market-based cost of capital for its regulated lines of business.

A. Proposition 103 and the *Calfarm* Decision

On November 8, 1988, the voters of California enacted Proposition 103 to make fundamental changes in the regulation of 18 lines of insurance, including automobile, property, casualty, and earthquake insurance. Prior to Proposition 103, California had employed an "open competition" system of regulation. Pet. App. 2a. Under Proposition 103, insurers were immediately required not merely to freeze their November 1988 rates, but to roll back those rates to 80% of their level one year earlier (November 8, 1987). Beginning one year after the enactment of Proposition 103—that is, on November 7, 1989, the end of the 1988-89 "rollback year"—insurers could apply for rate increases under a new regulatory regime requiring prior approval of the state Insurance Commissioner. The Commissioner must decide, among other things, whether the insurer's rate is excessive, but he is specifically directed to ignore " 'the degree of competition' " in the insurance market in making that determination. *See id.* at 6a, 71a. A rate increase *during* the "rollback year" was permitted only if " 'an insurer is substantially threatened with insolvency.' " *Id.* at 5a.

The rate rollback was immediately challenged in state court on federal- and state-law grounds. In *Calfarm Ins. Co. v. Deukmejian*, 771 P.2d 1247 (1989), the California

Supreme Court held that, as drafted, the rollback requirement violated the Takings Clause. The court focused on the "threatened with insolvency" standard for relief from the general rule requiring rollbacks to 80% of 1987 rates. Expressly relying on the confiscation standard set forth in *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944), the California Supreme Court held that "a rate may be confiscatory even though it does not threaten the insurer's solvency." *Calfarm*, 771 P.2d at 1253 n.9, 1254.[2] The court also observed that the insolvency standard "refers to the financial position of the company as a whole, not merely to the regulated lines of insurance," so that an insurer that was solvent based on out-of-state business or lines of insurance outside Proposition 103's reach would be precluded from relief from the rollback. *Id.* at 1254 (footnote omitted).

The state supreme court thus declared that limiting relief from the rollback requirement to cases involving threats of insolvency was invalid under the Takings Clause. The court then held, however, that the insolvency standard was severable from the remainder of Proposition 103. It therefore held that the enactment could constitutionally be applied as long as the Commissioner, in implementing it, compelled no rates below the minimum constitutional level. *Id.* at 1256-57.

B. The Commissioner's Implementation of Proposition 103

The state Insurance Commissioner began implementing Proposition 103, as modified by *Calfarm*, by issuing regu-

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[2] The court quoted the following standard from *Hope*: "'[I]t is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. [Citation.] By that standard the return to the equity owner should be commensurate with returns on investment in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.'" 771 P.2d at 1253 n.9 (quoting *Hope*, 320 U.S. at 603).

lations and conducting lengthy hearings on certain issues generic to the numerous applications seeking relief from the rollback. *See* Pet. App. 144a. When the new Commissioner, respondent John Garamendi, took office in January 1991 as the first elected (not appointed) holder of the office, he repealed the initial regulations and adopted a new set of regulations establishing a complex formula to determine the premiums that insurers were permitted to have collected in the rollback year (November 1988-November 1989). *See id.* at 14a-19a, 146a. He also conducted new hearings and adopted certain industrywide figures for key components of the formula, including the permitted cost of capital for all insurers, certain "efficiency standards" for all insurers, and the permitted amounts of capital (the "leverage ratios," defined as the ratios of premiums to surplus needed to back up policies, varying from line to line). *Id.* at 158a-159a, 163a-164a. The Commissioner derived the permitted (minimally non-confiscatory) cost of capital—found to be 10 percent—through evidence of the returns earned by the numerous firms in the California insurance market in the years preceding the rollback year. *See id.* at 188a.

In October 1991, the Commissioner selected 20th Century Insurance Company as the first insurer subject to a company-specific determination of its constitutionally acceptable rollback obligation. The Commissioner initially ordered a refund of more than $85 million (plus interest) for the rollback year. Pet. App. 149a. After proceedings before an administrative law judge, the Commissioner's final order, issued in May 1992, compelled a refund of $78 million plus interest (*ibid.*)—on an actual profit for the year of $76 million (*id.* at 126a, 205a).

C. This Litigation

A number of cases brought by 20th Century and by numerous insurers subject to the Commissioner's decisions, including petitioners here, were consolidated in the Superior Court of California. The complaints raised a vari-

ety of challenges both to the specific rollback order applicable to 20th Century and to the Commissioner's regulations and generic determinations.[3] The Superior Court held that the Commissioner's regulations were invalid on state- and federal-law grounds. Pet. App. 136a-213a.

In particular, the Superior Court concluded that the formula adopted by the Commissioner resulted in confiscation in violation of the Takings Clause. The court held that, to meet the *Hope* standard recognized in *Calfarm*, the Commissioner must allow a rate "that produces a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital." Pet. App. 177a. The court found that the "unique" formula adopted by the Commissioner (*id.* at 184a), through its complex operation, "always produces a lower return than even 10%," which the Commissioner himself determined to be the constitutional minimum. *Id.* at 177a n.20; *see also id.* at 184a (formula "automatically and inherently produces a minimum permitted premium which unavoidably does not permit even the lower boundary generic reasonable rate of return of 10% determined by the Commissioner"); *id.* at 198a (formula "always produces less than the 10% lower boundary rate of return"). The court also held that, under the *Hope* confiscation standard, the generic 10% figure could not validly be applied to 20th Century. The court explained that 20th Century's evidence established at least a 20% rate of return for its particular business, with its particular risks, and that there was "no evidence . . . contradicting 20th Century's evidence." Pet. App. 202a.[4]

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[3] Petitioners here were among the "Hartford Steam Boiler" group of plaintiffs, led by the Hartford Steam Boiler Inspection and Insurance Co.

[4] "Although *Hope* does not preclude a generic determination of a rate of return, it does contemplate . . . a rate of return which considers the capital needs of the regulated enterprise. What is missing here is evidence tying in the 10% return as reasonable

D. The 1994 California Supreme Court Decision

The California Supreme Court, with five of the seven Justices new to the court since *Calfarm*, reversed. Pet. App. 128a-129a; *Calfarm*, 771 P.2d at 1249, 1270. The court at no point found that insurers in this multi-competitor market had market power enabling them to impose supracompetitive prices on consumers or to earn returns on their capital incommensurate with their varying risks. Indeed, the court twice noted Proposition 103's express prohibition on even considering "the degree of competition" in the insurance market (Pet. App. 6a, 71a) and accepted that this market falls "outside the monopoly or public utility setting" (*id.* at 72a). *See also id.* at 86a. The court likewise made no effort to explain, in basic mathematical terms, whether the Commissioner's complex formula did or did not lead to revenues for the regulated business sufficient to cover (a) operating expenses plus (b) a market return on invested capital (the *Hope* standard); indeed, the court nowhere questioned the Superior Court's findings that the formula all but automatically produces less than the 10% return the Commissioner himself found to be the bare minimum for confiscation purposes. Nevertheless, the California Supreme Court upheld the Commissioner's formula and its application.

At the heart of the court's decision was its rejection of the *Hope* cost-of-capital standard, relied on in *Calfarm* (*see* note 2, *supra*), as a constitutional minimum. Pet. App. 79a. Thus, while accepting that the cost of capital "for 20th Century was found to be at least 20 percent," the court squarely rejected the proposition "that a regulated firm is entitled to its cost of capital." *Id.* at 116a. It based this holding on a reading of this Court's decisions that it reverted to repeatedly in its opinion. *E.g.*, *id.* at 76a-85a, 112a-116a, 123a-124a. And it stated that it was "fundamental error" for the Superior Court to have

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for 20th Century. Based on the only evidence in the record, 10% is confiscatory as to 20th Century." *Id.*

relied on the *Hope* standard as its test for confiscation. *Id.* at 83a.

The California Supreme Court purported to rest its holding on prior decisions of this Court. Having first made a passing reference to the general permissibility of "formulaic ratemaking" (Pet. App. 77a), the court went on to read this Court's decisions as establishing that a regulatory body may deny investors their interest in a market-based return on capital in order to provide further relief to consumers (*id.* at 79a). The critical passage quotes the *Hope* standard providing for such a return and then reasons:

> It must be emphasized that the foregoing describes an interest that the producer may pursue and not a right that it can demand. That interest is "only one of the variables in the constitutional calculus of reasonableness." (*Permian Basin Area Rate Cases*, [390 U.S. 747, 769 (1968)]).[5]

Pet. App. 79a. Immediately thereafter, the California Supreme Court's opinion stresses that " 'regulation does not insure that the business shall produce net revenues' " and that "such a firm has no constitutional right even against a loss." *Ibid.*, quoting *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 590 (1942), and citing *Market Street Ry. v. Railroad Comm'n*, 324 U.S. 548, 564 (1945). In the same vein, the opinion states that *Hope*

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[5] The court repeated precisely the same analysis, with the same excerpted quote from *Permian Basin*, a few pages later, stating that this was the "crucial" point, one that "deserves special emphasis" (Pet. App. 83a): the *Hope* standard of profit sufficient to attract capital at a cost commensurate with the particular firm's risk "is, of course, an interest that the producer may pursue. But it is not a right that it can demand. It is 'only one of the variables in the constitutional calculus of reasonableness.' " Pet. App. 84a (quoting *Permian Basin*). It repeated the point again at Pet. App. 85a-86a. *See* pages 15-17, *infra* (discussing quote).

itself allows regulation that provides only a "meager return." [6]

Based on that reading of this Court's decisions, the California Supreme Court held that, to establish confiscation, a regulated entity must make a showing of " 'deep financial hardship.' " Pet. App. 83a, quoting *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1181 n.3 (D.C. Cir. 1987) (en banc); *see* Pet. App. 81a. Although the court did not precisely define that test, it emphasized that, under its reading of *Hope*, "a regulated firm may claim that a rate is confiscatory only if the rate does not allow it to operate successfully." Pet. App. 82a; *see also id.* at 125a. And it declared that, even then, "the inability to operate successfully is a necessary—but not sufficient—condition of confiscation." *Id.* at 81a.[7] Finally, in explaining how its standards for confiscation should be applied, the California Supreme Court concluded that "confiscation is judged with an eye toward the regulated firm as an enterprise" (*id.* at 77a-78a): the analysis "depends in this context on the condition of the insurer as a whole—and not on the fortunes of any one or more of its lines[]" of business that are subject to regulation by California under Proposition 103. *Id.* at 99a; *see also id.* at 118a.

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[6] "The *Hope* court itself expressly held that '[r]ates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return . . . .' (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 605.)" Pet. App. 80a. The court repeated this truncated quote at Pet. App. 114a. *See* pages 17-19, *infra* (discussing quotes).

[7] Before the courts below, the Commissioner urged essentially that analysis (*see* Br. of Commissioner in Cal. S. Ct. at 58-61) and added that, while "it is not clear what showing is required to establish confiscation" (*id.* at 60), an individual regulated firm apparently may not complain of confiscation if the rate it is allowed permits it to recover "out-of-pocket costs" (Reply Br. of Commissioner in Cal. S. Ct. at 40).

The California Supreme Court therefore rejected the confiscation challenges to the Commissioner's formula, despite the undisturbed finding of the Superior Court that the formula all but automatically denies insurers even the generic industrywide rate of return (10 percent) that the Commissioner found constitutionally minimal. The California Supreme Court also rejected 20th Century's as-applied challenge, performing its own quick calculation of the profit that 20th Century would be left with for 1989 (starting from the actual profit of $76 million) after subtracting the $78 million refund but adding back in the excess federal income taxes that 20th Century would have saved if it had charged only the lower rates now allowed by the Commissioner. Pet. App. 126a. That method, by the Commissioner's own figures, produces less than an 8 percent return.[8]

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[8] The California Supreme Court miscalculated the result produced by its own method, arriving at an 11 percent return (which is still less than the undisputed 20% cost of capital of 20th Century). It added back to 20th Century's 1989 after-tax profit of $76 million the full $29 million in federal income taxes paid in that year (then subtracted the $78 million refund ordered, arriving at $27 million in profit, representing an 11% return on $243 million of surplus). Pet. App. 126a. But the Commissioner himself has recognized that, even with the lower rates approved by the Commissioner, 20th Century would still have owed roughly $8.5 million of the $29 million in federal income taxes it paid in 1989. The proper result (under the add-back principle used by the California Supreme Court), therefore, would be a profit of roughly $18.5 million ($76 million actual profit plus $20.5 million in recouped federal taxes, minus the $78 million refund), amounting to less than an 8 percent return. *See* State Farm Reply Br. in Superior Ct. at 4. The actual bottom line for 20th Century, in short, is a return significantly below the 10% figure the Commissioner deemed constitutionally necessary.

REASONS FOR GRANTING THE PETITION

The California Supreme Court has adopted a fundamentally erroneous view of federal constitutional standards for nonconfiscatory regulation of a firm's rates. First, without offering a definition of the supposedly lower constitutional floor, the court rejected the standard set forth in *Hope*, in favor of a standard of "deep financial hardship." Repeatedly noting that a regulated firm has no constitutional right to a profit at all, the court thus held that it was "fundamental error" to require, as the Superior Court had done, rates adequate to "produce[] a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital." Pet. App. 83a-84a. Second, the California Supreme Court's insistence that confiscation analysis must focus "on the condition of the insurer as a whole" (*id.* at 99a) is naturally read as meaning that regulated, in-State lines of business may be subjected to otherwise-confiscatory rates as long as the enterprise as a whole, including unregulated activities and out-of-State activities, is doing well enough. Both of these aspects of the decision below demand review.

In denying a constitutional entitlement to earn the *Hope* market-based return on regulated activities, the court below not only relied on a patent misreading of this Court's decisions but repudiated the standards widely accepted by other courts. Indeed, the court's new standard conflicts with the standards recognized by the earlier California Supreme Court's decision in *Calfarm* (*see* pages 3-4, *supra*) and by the Ninth Circuit's decision striking down a Nevada measure based directly on Proposition 103. *Guaranty Nat'l Ins. Co. v. Gates*, 916 F.2d 508 (9th Cir. 1990).[9] And the California Supreme Court's

[9] The cases are legion that recognize *Hope*'s cost-of-capital standard as a constitutional minimum. *See, e.g., Tennessee Gas Pipeline Co. v. FERC*, 926 F.2d 1206, 1208 (D.C. Cir. 1991) ("utility investors must be allowed an opportunity to earn returns sufficient to 'attract capital'" (quoting *Hope*, 320 U.S. at 605)); *United Gas*

"enterprise as a whole" conclusion rests entirely on one decision of this Court, *Baltimore & O. R.R. v. United States*, 345 U.S. 146, 150 (1953), which does not support the extraordinary proposition that confiscation of regulated activities is permitted if the enterprise earns enough in unregulated activities to afford it. Any such principle, in fact, would be deeply incompatible with other decisions of this Court.

Not only is the decision below seriously wrong, but it carries with it enormous practical consequences. The legal standards announced by the California Supreme Court, if left unreviewed, could dramatically upset settled understandings (on which investors rely) in all forms of governmental ratemaking, most notably for the many public utilities regulated at the state and federal levels. And if California is permitted to impose confiscatory rates on multistate insurers, particularly if out-of-State resources are invoked to offset in-State deficiencies, the effects will unavoidably be felt in other States, creating an extraterri-

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Pipe Line Co. v. FERC, 618 F.2d 1127, 1133 (5th Cir. 1980), *cert. denied*, 450 U.S. 911 (1981) ("*Hope Natural Gas* requires that the allowed rate generate sufficient revenue for the capital costs of the business."); *Jersey Central, supra; In re Public Serv. Co. of New Hampshire*, 547 A.2d 269, 271 (N.H. 1988) (Souter, J.) ("a utility's threshold entitlement is to a rate of return equal to the cost of capital"); *South Central Bell Tel. Co. v. Louisiana Pub. Serv. Comm'n*, 594 So. 2d 357, 362 (La. 1992) (same); *Central Maine Power Co. v. PUC*, 163 A.2d 762, 769 (Me. 1960) (same); *Mountain States Tel. & Tel. Co. v. Department of Pub. Serv. Regulation*, 624 P.2d 481, 482-83 (Mont. 1981) (same); *Alabama Power Co. v. Alabama Pub. Serv. Comm'n*, 422 So. 2d 767, 773 (Ala. 1982) (same).

On the other hand, several state supreme courts have disclaimed *Hope* as a constitutional minimum, based on the same errors in construing this Court's precedents as the California Supreme Court made. *See Ohio Edison Co. v. PUC*, 589 N.E.2d 1292, 1299-1300 (Ohio 1992); *Kansas Gas & Elec. Co. v. State Corp. Comm'n*, 720 P.2d 1063, 1071 (Kan. 1986), *prob. jur. noted*, 479 U.S. 1082, *appeal dismissed*, 481 U.S. 1044 and 483 U.S. 1036 (1987); *Pennsylvania Elec. Co. v. Pennsylvania PUC*, 502 A.2d 130, 134 (Pa. 1985), *appeal dismissed*, 476 U.S. 1137 (1986).

torial impact of the sort this Court has often condemned. *See, e.g., Healy v. The Beer Institute, Inc.*, 491 U.S. 324, 336-37 (1989).

More immediately, the numerous insurers with rollback-year cases before the Commissioner (having awaited this "test case") will be governed by the standards announced in the decision. Already, based on the formula upheld by the court below, the Commissioner has issued refund orders for the rollback year in amounts totalling more than $2.75 billion. *See* "Prop. 103 Rollback Orders," *Los Angeles Times*, Nov. 23, 1994, p. D3 (1991 order totalling $1.57 billion; orders issued Nov. 21, 1994, totalling $1.25 billion).[10] The standards also will govern the Commissioner's exercise of authority in setting the rate limits applicable to years subsequent to the rollback year. Both as to outstanding and future rollback orders, and as to post-1989 proceedings, the legal standards set forth by the California Supreme Court will place tremendous pressure on insurers to compromise their otherwise-legitimate claims of constitutional right. These standards are demonstrably incorrect, and they should not be allowed to stand.

A. The *Hope* Cost-of-Capital Standard for Confiscatory Rate Regulation Is a Constitutional Minimum

This Court recently summarized the basic constitutional doctrine applicable to regulation of rates. *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989). "The guiding principle has been that the Constitution protects utilities from being limited to a charge for their property serving the public which is so 'unjust' as to be confiscatory." *Id.* at 307. The Court explained that, under the "fair value" rule of *Smyth v. Ames*, 169 U.S. 466 (1898), this requirement for many decades was applied to protect "the

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[10] Rollback orders have been issued to the following petitioners in the following (rounded off) amounts: $138 million (FEDERAL); $65 million (HOME); $30 million (TRAVELERS); $73 million (GREAT AMERICAN); $37 million (Century-National); $17 million (GENERAL ACCIDENT); and $43 million (ZURICH).

actual present value" of the firm's property at the time of regulation. 488 U.S. at 308-09. As the Court further noted, however, the decision in *Hope Natural Gas* established that the constitutional standard could properly be applied to the historical cost of the firm's property, *i.e.*, to the invested capital, rather than to its present market value. 488 U.S. at 310.

The standard laid down in *Hope* is straightforward: "[I]t is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. . . . By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." 320 U.S. at 603. Even since *Hope* was decided in 1944, this has been the accepted standard defining the basic, minimum constitutional entitlement.[11] This standard, of course, by its terms points to the *market* as the basis for determining the necessary return to investors commensurate with the risks they assume in investing in the particular company, *i.e.*, the cost of capital.[12] Since profits

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[11] *See Duquesne*, 488 U.S. at 310 (quoting *Hope*, 320 U.S. at 605: the Constitution is satisfied by "[r]ates which enable [a] company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risk assumed"); *id.* a 311-12 (finding "overall impact" of rate order "not constitutionally objectionable" where rates do not impede "ability to raise future capital" and are not "inadequate to compensate current equity holders for the risk associated with their investments"). *See also* note 9, *supra*.

[12] The California Supreme Court itself explained: "'Cost of capital' may be defined as the rate of return available in the marketplace on investments comparable in terms of risk and otherwise or, more practically, as the expected rate of return a hypothetical investor would require to take a position in *the firm in question*." Pet. App. 30a (emphasis added).

earned are what is left over to pay investors after paying operating expenses, the *Hope* standard simply provides for a firm to earn its expected market-based return considering the normal relation of risk and return (anything less will send capital to other businesses; anything more will exceed what is needed to attract capital in competition with other investments).[13]

The California Supreme Court, however, rejected this accepted understanding. Although it quoted the *Hope* standard, it declared that a market-based return on capital was simply an investor interest in the constitutional calculus, not a constitutional right, and that investors had no right to any profit whatsoever. It thus held that a firm is *not* entitled to its market-based return covering its cost of capital but, as part of a balancing process (taking into account the interests of consumers), could be compelled to accept some lower return, even a loss. As we discuss, each step by which the court reached this conclusion rests on a serious misunderstanding and misapplication of this Court's decisions.

1. The California Supreme Court's first fundamental error was its simple misreading of *Permian Basin* as holding that the investor interest in a return meeting the *Hope* standard may be set aside, as part of a regulatory balancing process, in order to accommodate consumer interests. The court made this error partly by misquotation. After setting out the *Hope* standard as defining the investor's interest, the California Supreme Court said: "That interest is 'only one of the variables in the constitutional calculus of reasonableness.'" Pet. App. 79a (quoting *Permian Basin*, 390 U.S. at 769); *id.* at 85a-86a. But what *Permian Basin* actually says is that "*in-*

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[13] The California Supreme Court and the Commissioner recognized that the market requires higher returns for firms with higher risks: they acknowledged, in the opinion and in the regulations applicable to years after the rollback year, that an insurer with less surplus carries a higher risk and for that reason is entitled to a higher cost of capital. *See* Pet. App. 38a, 101a-102a.

vestors' interests provide only one of the variables . . . ." 390 U.S. at 769 (emphasis added). Since the broad notion of "investors' interests" hardly stops at constitutional minima, but extends to any achievable level of profit, this Court's uncontroversial observation in *Permian Basin*, when quoted in full, plainly does *not* say that the specific, minimum investor interest in meeting the *Hope* standard is to be balanced against consumer interests.

The California Supreme Court also evidently confused a statutory point in *Hope* and *Permian Basin* with a constitutional point. *Hope* observes that the familiar "just and reasonable" standard applicable *under the Natural Gas Act* states a statutory upper bound on permissible rates, so that "[t]he rate-making process *under the Act*, *i.e.*, the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests." 320 U.S. at 603 (emphasis added). *Permian Basin* makes the same point about statutory protection of consumer interests, quoting the above sentence from *Hope* as defining "the broad zone of reasonableness permitted *by the Act*." 390 U.S. at 770 (emphasis added). But nothing in either *Hope* or *Permian Basin* says that the *constitutional floor* is anything other than the investor interest in a market-based return on capital described in *Hope*.

To the contrary, *Permian Basin* makes clear that the bottom of the statutory zone of reasonableness is the constitutional *Hope* standard and that investor and consumer interests may be balanced only *within* that zone. 390 U.S. at 770 ("the just and reasonable standard of the Natural Gas Act 'coincides' with the applicable constitutional standards," quoting *FPC v. Natural Gas Pipeline Co.*, 315 U.S. at 586); *id.* at 792. The D.C. Circuit articulated this well-accepted understanding of *Hope* as early as 1950, explaining that "the minimal requirements for protection of investors outlined in the *Hope* case" define the constitutionally mandated lower bound of the zone of reasonableness established by statutes like the Natural Gas Act, which "is bounded at one end by the investor

interest against confiscation and at the other by the consumer interest against exorbitant rates." *Washington Gas Light Co. v. Baker*, 188 F.2d 11, 15 (D.C. Cir. 1950) (per Bazelon, J.), *cert. denied*, 340 U.S. 952 (1951). *See Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d at 1177 (quoting this passage with approval).[14] The California Supreme Court simply misread *Permian Basin* (and *Hope*) as permitting downward departures from the *Hope* cost-of-capital standard.

2. In addition to (erroneously) reading *Permian Basin* as authority for balancing away investor interests in the minimal *Hope* standard, the California Supreme Court invoked this Court's precedents to support the proposition that, as a constitutional matter, a regulated firm is not entitled to any profit at all. In reaching this conclusion, the court relied on *Hope* itself, on *FPC v. Natural Gas Pipeline Co.*, and on *Market Street Ry.* Again, however, the California Supreme Court plainly misread each of those authorities, none of which undermines the constitutional right of a firm to earn its market-based return on capital.

With respect to *Hope*, the state supreme court asserted that *Hope* itself approved regulation that " 'might produce only a meager return . . . .' " Pet. App. 80a, 114a. The full quote, however, says that regulation "might produce only a meager return *on the so-called 'fair value' rate base*." 320 U.S. at 605 (emphasis added). The quoted sentence thus has nothing to do with a supposed relaxation of the "cost of capital" standard set forth elsewhere in *Hope*. It is instead part of the very different discussion

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[14] *Jersey Central*, approving the *Washington Gas Light* formulation, thus could not support the California Supreme Court's notion (Pet. App. 83a, 125a) that "deep financial hardship" sets a constitutional floor below what *Hope* requires. Indeed, the court in *Jersey Central* itself explained that what it meant was precisely "the sort of deep financial hardship *described in Hope*." 810 F.2d at 1181 n.3 (emphasis added). *Jersey Central*, in short, is not authority for a standard different from *Hope*.

rejecting the doctrine of *Smyth v. Ames*, which held that the base to which the standard must be applied is the present "fair value" of a firm's assets (rather than the invested capital, as *Hope* held to be permissible). *See Duquesne*, 488 U.S. at 308-10.

The California Supreme Court equally misread the Court's statement in *FPC v. Natural Gas Pipeline Co.* that "regulation does not insure that the business shall produce net revenues." 315 U.S. at 590, *quoted at* Pet. App. 79a. This Court did not say—and, quite obviously, would not say—that regulators may impose a loss on a firm by taking away the expected return that it earned, operating efficiently, in the market. The Court was merely observing that it is up to the firm to *earn* its profit in the market: it has no constitutional entitlement to be subsidized by government or to receive a noncompetitive return, whether based on market power or on inefficient operations. Thus, the Court explained that "the hazard that the property [of a firm] will not earn a profit remains on the company in the case of a regulated, as well as an unregulated business": government-set rates must be "sufficient, having in view the character of the business, to secure a fair return upon the rate base *provided the business is capable of earning it.*" 315 U.S. at 590 (emphasis added).

For essentially the same reason, the California Supreme Court was far off base in its interpretation of the ruling in *Market Street Ry.* that the Constitution does not guarantee a firm against a loss. *See* Pet. App. 79a. The Court in *Market Street Ry.* merely concluded that government is under no duty to save a firm from the losses it incurs in the marketplace on its own. The Court explained that a firm like the Market Street Railway Company, which could not otherwise sustain itself, could not demand a particular rate if it "has not succeeded in maintaining its service on a paying basis" *in the market*. 324 U.S. at 566. Because the firm could not earn a return on its capital in an unregulated market, it could not invoke the decisions,

including *Hope*, applicable to firms "whose economic situation would yield a permanent profit, denied or limited only by public regulation." 324 U.S. at 566.[15] The present case, of course, involves a government limitation of profits earned in a (well-functioning) market, so *Market Street Ry.* is entirely irrelevant to the issue presented.

3. The California Supreme Court's error in construing constitutional standards obviously was critical to its judgment. This Court, of course, reaffirmed in *Duquesne Light Co.* that the Constitution does not prescribe methodologies, but is satisfied as long as the end result of rate regulation is non-confiscatory. 488 U.S. at 314-16. But the very error made by the California Supreme Court was in the standard to be applied in assessing the constitutionality of the end result. This is not a case, therefore, in which criticism of the particular components of a regulator's method for setting rates can be deemed beside the point, with only the end result tested against constitutional guarantees. The standards for testing the end result are themselves at issue.

The court below, moreover, made clear that its pronouncements as to the meaning of the Takings Clause were central to its entire opinion. It stated the standards for determining confiscation again and again, as the "crucial" points (Pet. App. 83a), in rejecting the various arguments made by the insurers. *See* pages 7-9, *supra*. And the court said over and over, in rejecting aspects of the Superior Court's ruling, that it was the trial court's misunderstanding of confiscation standards that "fatally tainted" the trial court's decision. *E.g.*, Pet. App. 115a, 118a, 120a.

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[15] The Court added that Market Street Railway Company *could not* earn a return on the investors' capital in the free market: higher prices would simply drive away too many consumers. 324 U.S. at 565. In that circumstance, the investors' capital lacked even its face value (but had only salvage value), and the Constitution "cannot be applied to insure values or to restore values that have been lost by the operation of economic forces." *Id.* at 567.

The centrality of the court's rejection of the *Hope* cost-of-capital standard is further confirmed by the court's application of its new standard—in particular, by what is wholly missing from that application. As noted, the California Supreme Court studiously avoided (as Proposition 103 commanded) any finding about market dysfunction demonstrating returns incommensurate with the risks of particular firms in a competitive market (which would be implausible in a market with hundreds of competing firms). At least as striking in its absence is any disagreement by the California Supreme Court with the trial court's findings that the Commissioner's formula all but automatically produces less than even the 10% industry-wide rate of return that the Commissioner himself deemed the minimal non-confiscatory rate. *See* page 6, *supra*. Likewise, the California Supreme Court undertook no effort to explain how, if at all, the formula produces a result matching the *Hope* standard of operating expenses plus a market-based return on proper capital, even assuming the validity of various adjustments to the permitted expenses and capital. Under the California Supreme Court's standards, all of these matters were irrelevant to the constitutional inquiry.[16] Those standards are wrong and should be reviewed.

B. Confiscatory Limits on Regulated Lines of Business Cannot Be Justified By Overall Enterprise Profits

In denying that a regulated firm is entitled to earn its market-based return on its regulated activities, the California Supreme Court stated several times that confiscation standards must be applied to the insurance companies' entire businesses, rather than separately to the regulated lines of insurance. *See* Pet. App. 77a-78a, 99a, 118a. If that conclusion is applied according to its literal terms—

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[16] The court's cavalier miscalculation of 20th Century's attributed return for 1989 (*see* note 8, *supra*) additionally confirms that the court deemed that result immaterial under its interpretation of the proper constitutional standards.

and the Commissioner has not indicated that he reads it any other way—it would mean that there can be no confiscation in the State's regulation of the rates for particular regulated lines of business as long as no confiscatory return is being forced on the enterprise as a whole, including *out-of-State* and *unregulated* lines of business. That proposition is insupportable.

The sole authority cited by the California Supreme Court for this extraordinary doctrine—this Court's 1953 decision in *Baltimore & O. R.R. v. United States, supra*—does not support it. It is one thing to say, as *Baltimore & O. R.R.* did on its facts, that a regulator may decide how to group together various pieces of a *fully regulated* business in applying minimal standards for compensatory rates. 345 U.S. at 150 ("so long as rates as a whole afford railroads just compensation for their over-all services to the public the Due Process Clause should not be construed as a bar to the fixing of noncompensatory rates for carrying some commodities when the public interest is thereby served"). It is an entirely different matter to say that a regulator may insist on a confiscatory rate for the business under its authority because *other* business, *not* under its authority, generates enough profits to keep the firm as a whole sufficiently profitable. That remarkable proposition—nowhere found in *Baltimore & O. R.R.*—is equivalent to saying that confiscation is permissible if the victim is wealthy enough to afford it.

Any extension of *Baltimore & O. R.R.* to these lengths would be inconsistent with other decisions of this Court. In *Northern Pacific R.R. v. North Dakota*, 236 U.S. 585 (1915), for example, the Court ruled that "it would be no answer [to a challenge to a State's confiscatory rate for particular carriage] to say that the carrier obtains from its entire intrastate business a return as to the sufficiency of which in the aggregate it is not entitled to complain." *Id.* at 595-96 (citing earlier cases where "the adequacy of the receipts from [a firm's] entire business did not enter into the question"). *See also Norfolk & Western R.R. v.*

Conley, 236 U.S. 605, 608-09 (1915). The discussion of these authorities in *Baltimore & O. R.R.* (345 U.S. at 148-49) says almost nothing to clarify how far government may go in looking to the entire business, even the regulated parts in the aggregate, to justify confiscatory regulation of particular lines of business in isolation. And any expansive reading of *Baltimore & O. R.R.* would seem to run headlong into this Court's recent ruling that a State may not justify a taking of one parcel of land "in light of [the] total value of the taking claimant's other holdings in the vicinity." *Lucas v. South Carolina Coastal Council*, 112 S. Ct. 2886, 2894 n.7 (1992).

In short, the Constitution and this Court's precedents cannot reasonably be construed to entitle a State to impose confiscatory rates on regulated aspects of an enterprise simply because the enterprise is doing well enough elsewhere in its business. That principle would have a dramatic impact on many of petitioners, who sell insurance outside California and who sell insurance inside California in lines (*e.g.*, life insurance) not subject to Proposition 103. Unless the Commissioner makes clear that he does not read the California Supreme Court's opinion to establish such a principle, this Court should review and reverse this aspect of the decision as part of the question presented. A regulated firm should be held entitled to a non-confiscatory rate, based on its cost of capital, for its regulated business.

CONCLUSION

The petition for a writ of certiorari should be granted.

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No. 94-1120

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

CENTURY-NATIONAL INSURANCE CO., *et al.*,
Petitioners,

v.

JOHN GARAMENDI, Insurance Commissioner
of the State of California,
Respondent.

On Petition For A Writ of Certiorari to the Supreme Court of California

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RESPONDENT' S BRIEF IN OPPOSITION

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22

QUESTIONS PRESENTED

Whether insurers may challenge rate regulations as violating the Takings Clause before those regulations have been applied to them.

Whether Respondent's rate regulations yield a 10% rate of return on the firm's regulated business, and whether, if they do, that renders the regulations confiscatory.

CONTENTS

QUESTIONS PRESENTED i

TABLE OF AUTHORITIES iii

INTRODUCTION 1

STATEMENT OF THE CASE 3

REASONS TO DENY THE WRIT 6

I. Claims Regarding Regulations That Have Not Been Applied to Petitioners Are Not Ripe for Review by This Court. 7

II. Petitioners Fail to Prove the Confiscation Case for 20th Century That 20th Century Never Even Tried to Prove. 10

III. The Decision Below Properly Rests on an Assessment of the Firm's Regulated Business. 16

CONCLUSION 18

TABLE OF AUTHORITIES

CASES

20th Century Insurance Co. v. Garamendi, 8 Cal. 4th 216, 878 P.2d 566, 32 Cal. Rptr. 2d 807 (1994) 1

Bowles v. *Willingham*, 321 U.S. 503 (1944) 10

Calfarm Insurance Co. v. Deukmejian, 48 Cal. 3d 805, 771 P.2d 1247, 258 Cal. Rptr. 161 (1989) 3, 17

California State Auto. Ass'n v. Maloney, 341 U.S. 105 (1951) 10

Concrete Pipe & Prods., Inc. v. Construction Laborers Pension Trust, ___ U.S. ___, 116 S. Ct. 2264 (1993) 10

Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989) 8, 12, 16

Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944) 8, 9, 10, 11

Kaiser Aetna v. United States, 444 U.S. 164 (1979) . 7

New Orleans Pub. Serv., Inc. v. Council of New Orleans, 491 U.S. 350 (1989) 8

Pennell v. City of San Jose, 485 U.S. 1 (1988) 8

In re Permian Basin Area Rate Cases, 390 U.S. 747 (1968) 11, 12, 18

Prentis v. Atlantic Coast Line Co., 211 U.S. 210 (1908) 8

STATUTES

Cal. Ins. Code § 1861.05(a) (West 1993) 3, 4

No. 94-1120

IN THE
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CENTURY-NATIONAL INSURANCE CO., *et al.*,
Petitioners,

v.

JOHN GARAMENDI, Insurance Commissioner
of the State of California,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF CALIFORNIA

Respondent John Garamendi, Insurance Commissioner of the State of California, respectfully urges the Court to deny the petition of Century-National Insurance Company, *et al.* ("Pet."), seeking review of the decision of the Supreme Court of California in *20th Century Insurance Co. v. Garamendi*, 8 Cal. 4th 216, 878 P.2d 566, 32 Cal. Rptr. 2d 807 (1994).

INTRODUCTION

Respondent California Insurance Commissioner John Garamendi has adopted regulations implementing the voter-enacted insurance-reform initiative, Proposition 103. In the decision below, the California Supreme Court reviewed those regulations and found them to be both facially constitutional and constitutional as applied to the rates of 20th Century Insurance Company and its affiliate. In a separate petition for certiorari, 20th Century and the State Farm companies

have asked this Court to review that decision. (No. 94-1119.)

Century-National and its Co-Petitioners have never had their respective rollbacks adjudicated by Respondent Commissioner. Consequently, their petition argues 20th Century's case—sometimes with claims 20th Century itself did not make—and attempts to challenge general ratemaking principles of the California regulations on the basis of Petitioners' speculation about how they may operate on Petitioners in the future. In large measure, Petitioners' speculations are demonstrably wrong. Their as-not-applied challenges have no merit.

To the extent that these Petitioners simply parrot 20th Century's arguments about confiscation principles, their claims suffer the same defects as 20th Century's: Their legal theory amounts to nothing less than a claim that the Constitution prohibits regulation from diminishing a firm's pre-regulation value. Their arguments about hypothetical orders that deny a firm any profit have nothing to do with the decision below, reviewing a rate order that provides a 10% rate of return.

To the extent that these Petitioners attempt to embellish 20th Century's case with erroneous numerology, they would abuse this Court's certiorari jurisdiction. They press upon the Court alternative ratemaking calculations, as if this were the Supreme Court of Accounting Errors. That their computations are erroneous only compounds the offense.

This Court wisely insists that judicial challenges to rate regulations be entertained only from final determination of the rate and only upon the constitutionally significant "end result" of regulation. There is only one end result thus far by which to measure the California regulations, the 20th Century decision. That decision's resulting one-year rate yields a 10% return, more than ample to cover the costs of the regulated business, including its capital costs. There is no need for this Court to review 20th Century's order, and

even less reason for this Court to entertain the claims of these Petitioners.

STATEMENT OF THE CASE

The petition of Century-National Insurance Co., *et al.*, accompanies that of 20th Century Insurance Co., *et al.*, in No. 94-1119 and seeks review of the same decision of the California Supreme Court.

In his brief in opposition in No. 94-1119, Respondent recounts the voters' passage of Proposition 103, the insurance-reform initiative; the decision of the California Supreme Court in *Calfarm Insurance Co. v. Deukmejian*, 48 Cal. 3d 805, 771 P.2d 1247, 258 Cal. Rptr. 161 (1989) ("*Calfarm*"), upholding the initiative's 20% rollback and one-year freeze against facial attack, subject to the right of insurers to have the rollback reduced to a lesser amount if necessary to avoid confiscation; Respondent's regulatory program to implement the initiative; and the extensive administrative and judicial litigation culminating in the unanimous decision of the California Supreme Court that is the subject of these petitions.

Because the Century-National petition makes a number of claims regarding the regulations upheld by the California Supreme Court, a proper evaluation of that petition requires review of those regulations. That evaluation necessarily begins with the 4,089 applications for exemption from the one-year rollbacks filed by some 460 insurers. (App. 34a.) In the nineteen months of her incumbency before Respondent took office, Respondent's predecessor had not adjudicated a single application to a final administrative decision. (App. 146a.) Furthermore, because no insurer could change a rate without the Commissioner's prior approval, Cal. Ins. Code § 1861.05(a) (West 1993), the Commissioner faced the daunting task of reviewing the application of every insurer seeking a rate change.

The task was made even more challenging by the fact that insurance companies routinely maintain parallel sets of

figures to describe their operations, each of which portrays the results of the operations differently. The decision below discusses three such parallel systems, which differ according to when expenditures and revenues are recognized, in the accounting rules employed, and in the treatment of reinsurance. (App. 14a-15a.) The choice among these different systems could, of course, materially affect the apparent profitability of a company's operations, and therefore the amount of rollback it could be made to refund in the rollback year and the reasonableness of a proposed rate change.

Respondent's solution to this regulatory challenge was to adopt rules that defined procedures, resolved generic issues, embodied regulatory policy, and enumerated the manner in which he would calculate whether the full 20% rollback would be confiscatory as to each company and, if it would, what lesser amount could constitutionally be ordered. Cal. Code Regs. tit. 10, §§ 2641.1-2645.9 (1994) (partially reprinted at App. 377a-399a). The same regulations defined how applications for future rate changes would be examined under the more generous statutory standard for rates after the initiative's first year, when the issue became whether the proposed rate would be "excessive, inadequate, unfairly discriminatory or otherwise in violation" of the rating laws. Cal. Ins. Code § 1861.05(a) (West 1993).

The fundamental aim of the rollback regulations is to determine the rollback rate by calculating the company's costs and adding a reasonable profit. They achieve this purpose by taking *each company's individual experience* and combining the figures in a prescribed formula that produces that company's "minimum permitted earned premium." Cal. Code Regs. tit. 10, §§ 2644.3, 2645.3(a).[1]

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[1]The basic ratemaking formula is:

$$\text{Min Permitted EP} = \frac{\text{losses} + \text{ALAE} + \text{fixed expenses} - \text{ancil income}}{1 - \text{varexp factor} - \text{profit factor} + \text{invest inc factor}}$$

(continued...)

Thus, each insurer's rollback is determined from *its own costs and its own revenues*. *Id.* §§ 2641.1-2645.9. However, each of these quantities may be limited by regulatory standards contained in the regulations. Thus, for example, the *allowable* expenses may not exceed the average expense ratio for each line of insurance, calculated separately according to the insurer's method of distribution (and concomitant cost structure). *Id.* §§ 2644.12, 2645.5.[2] To the reasonable

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[1](...continued)

where "EP" is "earned premium,"
"losses" is pay-outs on policies,
"ALAE" is "allocated loss adjustment expenses," mainly claim-defense costs,
"fixed expenses" corresponds roughly to overhead,
"ancil income" is ancillary non-premium income derived from insurance operations,
"var exp factor" (variable expense factor) refers to the agent's commission and the state premium-tax rates,
"profit factor" reflects the profit requirement and associated income-tax effects, and
"invest inc factor" (investment income factor) is the calculation of investment income on reserves and surplus, revenue that operates to reduce the required premium.

(App. 16a-18a.) The regulations further define several of these factors by subsidiary formulae.

[2]Taking the Homeowners Multiple Peril line as an example, an insurer that writes through independent agents (and thus must pay commissions) may have included in its recognized expenses its actual experience up to 40.86% of premiums. *Id.* § 2645.5(c), tab. line 1. By comparison, an insurer that is a "direct writer" (does not use agents, typically selling through the mail) may have an expense ratio of up to 24.28% of premiums. *Id.* These values were adopted in separate proceedings to determine the prevailing industry averages. (App. 3a.)

costs, the regulations add a profit term, which is 10% of the recognized surplus, plus an allowance for income taxes.[3]

This calculation of the rollback rate is performed separately for each line of insurance and then combined to determine the total rollback-year premiums the insurer could have charged to cover its reasonable costs and receive a 10% return on its capital necessarily employed in provision of the insurance. *Id.* §§ 2642.7(a), 2643.3(b), 2644.3, 2645.3. That rollback rate is subtracted from the rate the company actually charged in the rollback year, and that difference, together with interest, is the amount the insurer must refund to its customers. *Id.* § 2645.9. The actual calculations for 20th Century span some 26 pages, showing precisely how the Commissioner arrived at the 12.203% rollback order. (App. in Cal. S. Ct. at 11262-11287.)

REASONS TO DENY THE WRIT

In the present petition, scores of insurance companies whose rollbacks under Proposition 103 have *not* been determined seek review of the California Supreme Court's decision reviewing the rate order of 20th Century Insurance Company and its affiliate. This second petition appears to be making two arguments.

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[3]The profit is expressed as a percentage of recognized "surplus," the term for statutory capital. (App. 3a.) The amount of capital that is used and useful is calculated as a ratio ("leverage ratio") to premiums, which varies by line to reflect the differential risk associated with writing a dollar of premium in each line. Cal. Code Regs. tit. 10, §§ 2644.17, 2645.6. In the rollback year, the recognized surplus is the lesser of the company's actual surplus or the amount imputed by the regulatory leverage ratios, *id.* § 2645.6(c); in the prospective rate-approval process the imputed ratio is always used, *id.* §§ 2644.16, 2644.17, permitting the insurer that writes more premium on a given amount of surplus to enjoy a higher profit.

For the rollback year, the authorized rate of return is specified at 10%. *Id.* § 2645.6(a).

The first argument is simply a restatement of the 20th Century petition's claims about the fair-return standard. To the extent these Petitioners are merely repeating those claims, the purpose of this second petition is unclear, since these Petitioners could have joined in 20th Century's petition (as the State Farm companies did). The only embellishments to the 20th Century petition found in the present petition seem to consist of claims about the effect of the 20th Century rate order that even 20th Century did not attempt to prove.

The second argument just rails at mirages. Petitioners argue that the decision below could be read to call for the test of confiscatory rates to be applied to the company's non-regulated business, allowing otherwise confiscatory rates to be offset by profits outside the California insurance business. The California regulations clearly and explicitly calculate the authorized rate solely on the basis of the insurer's California, Proposition 103 business. The California Supreme Court clearly and explicitly approved them on that basis. Certiorari is not needed to review Petitioners' misconceptions to the contrary.

I. Claims Regarding Regulations That Have Not Been Applied to Petitioners Are Not Ripe for Review by This Court.

In large measure, this petition merely echoes the claims of 20th Century, and, to that extent, it can be viewed simply as an amicus brief in white covers. However, to the extent that these Petitioners invoke the Court's certiorari jurisdiction to mount a facial challenge to the California regulations, this petition fails the Court's established standards for reviewing rate cases.

Because the measure of confiscation is an "essentially ad hoc, factual inquir[y]," *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979), a full record of the impact of a challenged rule is essential to review. Particularly in ratemaking cases, that requires a concrete record of how the rules actually are applied before this Court will hear a

challenge to them. *E.g.*, *Pennell v. City of San Jose*, 485 U.S. 1, 9-11 (1988).

The Court has repeatedly held that challenges to ratemaking rules are not ripe for review until the challenger has completed the ratemaking process. *E.g.*, *New Orleans Pub. Serv., Inc. v. Council of New Orleans*, 491 U.S. 350 (1989); *Prentis v. Atlantic Coast Line Co.*, 211 U.S. 210 (1908). In cases claiming a ratemaking rule is confiscatory, the Court's ripeness requirements are not merely procedural rules, but reflect the substance of the Takings Clause jurisprudence.

The constitutionality of a rate, the Court has instructed, is not a function of the ratemaking rules but only of the "end result." *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944) ("*Hope*"). Whether there has been a taking does not depend on the specific rules of valuation or the individual cost calculations, but on whether the overall effects on the regulated entity are unreasonable.

> [I]t is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unreasonable, judicial inquiry . . . is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.

Id. The Court "reaffirm[ed] these teachings of *Hope*" in *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310 (1989) ("all of the subsidiary aspects of valuation for rate-making purposes [are] not properly. . . characterized as having a constitutional dimension, despite the fact that they might affect property rights to some degree").

Because the existence of "infirmities" in rate calculations cannot establish confiscation, these Petitioners' disembodied arguments about the California rules and rate components simply cannot serve as the basis for this Court to elucidate further the law of confiscation.

Ironically, Petitioners effectively urge the same point. They criticize the California regulations in part because the regulations specify a uniform rate of return, rather than

allowing each company to prove its entitlement to a higher return based on its individual circumstances. (Pet. at 6 n.4.) If the constitutionality of the rate requires consideration of each firm's circumstances, unconstitutionality can scarcely be shown without reference to those circumstances. Absent a final adjudication of these Petitioners' claims, no such showing can be made.

For example, as Petitioners themselves note, (Pet. at 17-18), this Court has said even a "meager return" may well not be confiscatory, depending on the overall effect of the rate order, an effect that may be dramatically different depending on the full ratemaking calculation. *Hope*, 320 U.S. at 605. Whether or not a given return is confiscatory will necessarily depend on how the various components of the rate calculations operate. Petitioners would be among the first to argue that those other components can be so formulated that the authorized return is not a meaningful "end result." Whether that is the case here cannot be assessed by examining the authorized rate of return in isolation.

This petition illustrates nicely the wisdom of the Court's stringent ripeness requirements in rate cases. Petitioners cannot show how the various regulations would affect them, so they are reduced to speculating about how the regulations will operate and arguing about how the regulations should be construed—that they "automatically" deny insurers the authorized 10% rate of return, (Pet. at 10, 20), that they will allow a confiscatory rate to be offset by non-California profits, (*id.* at 20-22). That these predicted interpretations are flatly wrong is less important here than what they say about the justiciability of Petitioners' claims. What Petitioners would call a "facial" challenge to the regulations is simply a request for an advisory opinion about the constitutionality of the regulations should they be implemented in the manner Petitioners predict.

II. Petitioners Fail to Prove the Confiscation Case for 20th Century That 20th Century Never Even Tried to Prove.

Petitioners largely duplicate the arguments of the 20th Century Petitioners in No. 94-1119, arguing that it is unconstitutional to authorize a rate of return lower than the company's supposed 20% minimum "cost of capital." As more fully explained in Respondent's brief in opposition to the petition for certiorari in No. 94-1119, that proposition is contradicted by established Takings Clause jurisprudence. Because Petitioners' formulation of the "cost of capital" is a function of the market price of a firm's equity (not its actual cost of servicing debt and making dividend payments), Petitioners are necessarily arguing that regulation cannot diminish the value of a regulated business. The law has long held to the contrary. *E.g.*, *Hope*, 320 U.S. at 601 ("the fact that value is reduced does not mean that the regulation is invalid"); *Concrete Pipe & Prods., Inc. v. Construction Laborers Pension Trust*, ___ U.S. ___, 116 S. Ct. 2264, 2291 (1993) ("our cases have long established that mere diminution in the value of property, however serious, is insufficient to demonstrate a taking"); *California State Auto. Ass'n v. Maloney*, 341 U.S. 105, 111 (1951) ("diminution in value . . . has never mounted to the dignity of a taking in the constitutional sense"); *Bowles* v. *Willingham*, 321 U.S. 503, 517 (1944) ("[o]f course, price control, the same as other forms of regulation, may reduce the value of the property regulated").

Furthermore, as also discussed more fully in Respondent's brief in No. 94-1119, (Resp't's Br. in Opp'n at 6-17), the authority claimed to be in conflict with the decision below is, in fact, fully consistent with it. The alleged "conflict" in fact turns on Petitioners' misuse of the term "cost of capital." What the cases describe as the constitutionally protected "capital costs" is debt service and dividend payments. What Petitioners claim as a constitutional entitlement is based on a hypothetical calculation of a profit level intended to entice prospective investors to provide

capital under terms favorable to the current owners of the firm. To reduce the constitutional test to such one-dimensional speculation was precisely what this Court rejected in *In re Permian Basin Area Rate Cases*, 390 U.S. 747 (1968) ("*Permian*"):

> The Commission cannot confine its inquiries either to the computation of costs of service or to conjectures about the prospective responses of the capital market; it is instead obliged at each step of its regulatory process to assess the requirements of the broad public interests entrusted to its protection by Congress.

Id. at 791.

Petitioners urge the Court to take this case precisely to establish the principle that confiscation is, indeed, limited to the conjecture about the capital market that constitutes their definition of "cost of capital." According to Petitioners, the cost-of-capital standard "of course, by its terms points to the *market* as the basis for determining the necessary return to investors." (Pet. at 14 (emphasis in original).) However, they refute their own claim in striving to avoid the holding of *Hope* that regulation "might produce only a meager return." 320 U.S. at 605. Petitioners would explain away that statement by claiming that *Hope* authorized a "meager return," but only if it is a meager return on the *market value* of the firm's equity, not if it is a meager return on a rate base that may differ from market value. (Pet. at 17-18.) How that is supposed to help Petitioners' case is not clear. As Petitioners themselves emphasize, *Hope* held that the return may be computed on a non-market, historical-cost basis, which may be considerably lower than market value. Petitioners' assertion that the constitutionally required standard is a full market return is thus inconsistent with *Hope's* approval of a "meager" market return.

Beyond its duplication of 20th Century's cost-of-capital argument, the Century-National petition reflects an interesting division of labor. The 20th Century Petitioners largely ignore the 10% return the rate order actually provides the

company, instead hypothesizing a 0% rate order and constructing a conjectural conflict with other cases on the constitutionality of such an order. The Century-National Petitioners, on the other hand, challenge the decision below by claiming that 20th Century didn't really get 10%.[4]

Nowhere in its adjudicatory hearing did 20th Century itself ever claim that it did not really get a 10% return. One searches the administrative decision in vain for any indication that the issue was presented to the agency. (App. 215a-369a.)[5] Examination of the argument may explain why.

In its review of the regulations, the superior court made three erroneous findings that led it to conclude that "the formula . . . always produces less than the 10% lower boundary rate of return and is, therefore, . . . unconstitutional." (App. 198a; *see also id.* 184a.) Although Petitioners claim the California Supreme Court "nowhere questioned" this conclusion, (Pet. at 7), making it an "undisturbed finding," (*id.* at 10), in fact the California Supreme Court explicitly identified the lower court's errors in the course of reversing that decision.

The first error by the superior court concerned the "recursiveness" of the formula.[6] By expressing certain

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[4]Petitioners are undaunted by the established law that confiscation does not occur simply because the regulated entity does not achieve the authorized rate of return. *Duquesne*, 488 U.S. at 312; *Permian*, 390 U.S. at 771.

[5]The "nobody gets 10%" argument first appeared in superior court, in what was supposed to be judicial review of the administrative decision, where it was authored not by 20th Century but by various insurer intervenors. The theory was first endorsed by 20th Century in a passing reference in its reply brief. (*See* App. in Cal. S. Ct. at 7577.)

[6]"Recursive" simply means that "the value solved for figures in the solution itself." (App. 70a.) For example, the final rate will typically include a commission for the agent, and that commission is typically a

(continued...)

expense and profit allowances as a percentage of the ultimate rate, a lesser quantity is permitted than if the formula expressed the allowances in terms of percentages of the rate actually charged (before the rollback). The superior court concluded that this quality in the regulations rendered them "unconstitutional." (App. 184a n.30.)

The California Supreme Court expressly rejected this conclusion of the lower court, explaining the logic of the mathematics and concluding that "'recursiveness' is not objectionable." (App. 70a.) The California Supreme Court also explained why use of the final rollback rate, rather than the pre-rollback rate actually charged, was necessary to avoid a windfall to an insurer (and loss to its policyholders) accruing simply from the fact that the company delayed its rollback beyond the year in which it was to be implemented. (App. 62a-64a.)

The second error of the superior court leading to its erroneous conclusion that "the formula . . . always produces less than . . . 10%" was its treatment of offsetting benefits enjoyed by the insurer when it pays its rollback. The regulations recognize that when the insurer issues a refund, its pre-tax income will go down, reducing its income tax liability. Similarly, the rollback reduces the premium, reducing agent commissions, to the insurer's benefit. The superior court found fault with the regulations on this account. (App. 205a-206a.) The California Supreme Court explicitly approved and explained the logic of this aspect of the formula, which lies in the "matching" of related items of revenue and expense. (App. 18a, 126a.)

The third error was the apparent conclusion that expense disallowances and non-recognition of capital not used and

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[6](...continued)
percentage of the final rate. The "recursive" quality of the formula permits it to arrive at a proper final rate, taking into account such quantities that depend themselves on the final rate. (*Id.*)

useful was confiscatory. (App. 184a n.30, 205a.) Again, the California Supreme Court reversed:

> Contrary to the superior court's evident assumption, the ratemaking formula does not purport to guarantee the individual insurer a rate covering its cost of service plus 10 percent of its capital base independent of the various adjustments, exclusions, etc., incorporated therein.
>
> We do not think it improper—constitutionally or otherwise—for the rate regulations as to rollbacks to recognize as the insurer's cost of service only the *reasonable* cost of providing insurance.

(App. 72a.)

The cumulative impact of these errors is shown in the insurers' favorite charge: that the $78 million rollback ordered exceeds the entirety of 20th Century's 1989 profit of $76 million. (Pet. at 5, 10.) That claim gave the California Supreme Court pause, but, "[o]n closer consideration, . . . the argument turns out to be specious." (App. 126a.) When the calculations are purged of the specified errors, the missing profit is found and a return of at least 10% is confirmed. (*Id.*)

Perhaps the most obscure issue in a case rich in obscurity concerned whether the resulting rate of return could be called slightly above or slightly below the 10% at which the Commissioner put the profit. In the superior court (again, raising the issue for the first time well after the administrative hearing), certain insurer intervenors and amici pointed out that the formula reduces the recognized surplus in proportion to the rollback percentage. This, they claimed, denied 20th Century its 10% profit on the increment of surplus thereby excluded, leaving the company with less than a 10% profit on the entirety of its surplus. (*E.g.*, Br. of State Farm Ins. Cos. as Amicus Curiae in Super. Ct. at 5.) In response, the Commissioner pointed out (a) that the same phenomenon eliminated consideration of the investment income on the same surplus, thereby reducing the rollback;

(b) the same phenomenon also reduced recognized reserves and investment income on reserves, by an amount far larger than the return on unrecognized surplus; and (c) that the net effect of the phenomenon cited by the insurers was to *increase* the actual rate of return from 10% to 10.56%. (Comm'r's Reply to Br. of Amicus Curiae State Farm Cos. in Cal. S. Ct. at 17-19.) The California Supreme Court took note of the phenomenon in its decision.[7] (App. 120a.)

The Century-National Petitioners would now relitigate the issue in this Court. Their petition repeats the "specious," (App. 126a), argument about the rollback exceeding the company's profits, (Pet. at 10), and then adds the charge that "by the Commissioner's own figures" it yields "less than an 8 percent return." (*Id.*) The authority for this assertion appears in the associated footnote 8, which cites to *State Farm's* amicus brief in the superior court—where that company first raised the numerical canard which the Commissioner refuted in the brief cited above, a response Petitioners simply ignore in order to claim that State Farm's 8% is somehow "the Commissioner's own figures."

Beyond what this passage reveals about Petitioners' brief, the issue illustrates what this Court has previously said about what is and is not a constitutional issue in reviewing rate orders:

> The economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result. The Constitution is not designed to

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[7]The court noted the exclusion of investment income and concomitant benefit to the insurer, concluding, "As a result, the firm apparently experienced a net benefit." (App. 120a-121a.) In its petition for rehearing, 20th Century tendered new numbers purporting to dispute the "net benefit," to which the Commissioner responded. Apparently reaching the sensible conclusion that nothing of constitutional moment required resolution of this quantitative quarrel over one or two percentage points, in its order denying rehearing the court deleted the "net benefit" sentence, (App. 135a), leaving intact the finding that the phenomenon excluded investment income to 20th Century's advantage, (App. 120a).

> arbitrate these economic niceties. . . . The Constitution protects the utility from the net effect of the rate order on its property. Inconsistencies in one aspect of the methodology have no constitutional effect on the utility's property if they are compensated by countervailing factors in some other aspect.

Duquesne Light Co. v. *Barasch*, 488 U.S. at 314.

Two facts emerge from the confusion sown by the insurers' efforts to help 20th Century prove the case it did not try to prove: First, nothing in the numerical debate rises to the dignity of a constitutional issue worthy of this Court's attention. And second, far from leaving the superior court's conclusions about how the regulations actually operate "undisturbed," (Pet. at 10), the California Supreme Court wholly repudiated those conclusions on appeal: "In this regard too, the superior court's conclusion is substantially erroneous." (App. 70a.)

III. The Decision Below Properly Rests on an Assessment of the Firm's Regulated Business.

In the state courts, 20th Century challenged the calculations underlying its rate order on the ground that the resulting rates would be "confiscatory" for certain lines of insurance. (App. 153a.) In the decision below, the California Supreme Court considered and rejected that claim, reasoning that confiscation is properly measured, not by the profitability of any isolated portion of the company's regulated business, but by the overall results of "the regulated firm as an enterprise." (App. 99a.)

Remarkably, Petitioners now purport to draw from this the notion that the California Supreme Court would evaluate confiscation on the basis of the insurer's "entire business, rather than separately [for] the regulated lines of insurance."

(Pet. at 20.)[8] The decision is precisely to the contrary. The reference to the "regulated firm as an enterprise" plainly means that the regulated activities of the firm (here, the California insurance governed by Proposition 103) are treated as an enterprise, and confiscation is measured by the end result of those activities.

Even if Petitioners could plausibly argue a different meaning of the California Supreme Court's language, that different meaning would have nothing to do with its decision. The "applicability" section of the California regulations at issue in this case makes it plain that the regulations are limited to California operations: "This subchapter applies to all rates charged for insurance on risks or on operations *in this state* . . . ." Cal. Code. Regs. tit. 10, § 2641.2 (emphasis added). The regulations contain detailed rules of "inter-jurisdictional allocations" for segregating the California costs and revenues of a multi-state insurer from its non-California data. *Id.* § 2643.6. Petitioners may choose to worry that the California Supreme Court would allow non-jurisdictional business to be taken into account,[9] but the decision they ask this Court to review plainly does not.

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[8]Even more astounding is Petitioners' claim that "the Commissioner has not indicated that he reads it any other way." (Pet. at 21.) In its petition for rehearing before the California Supreme Court, 20th Century made the same argument, and the Commissioner answered that the insurer's interpretation of the decision was incorrect. He said that, consistent with both the decision and the regulations, questions of confiscation were to be evaluated "by summing the results of all the insurer's Proposition 103-jurisdictional business." (Answer to Pet. for Reh'g in Cal. S. Ct. at 4.)

[9]One would expect such worry to have been dispelled by the same court's decision in *Calfarm*, invalidating a portion of Proposition 103's rollback provision as written precisely because it permitted reliance on a company's non-California, non-Proposition 103-regulated profits to offset losses in Proposition 103 lines. 48 Cal. 3d at 818-19, 771 P.2d at 1254, 258 Cal. Rptr. at 168.

CONCLUSION

This Court has accorded a strong presumption of validity to the work of expert administrative agencies charged with setting just and reasonable rates.

> [T]hose who would overturn the Commission's judgment undertake "the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences." . . . We are not obliged to examine each detail of the Commission's decision; if the "total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end."

Permian, 390 U.S. at 767 (quoting *Hope*, 320 U.S. at 602).

No effort has been made, either by these Petitioners or by the 20th Century Petitioners, to make the kind of showing the cases demand of a firm claiming its business has been confiscated by a rate order. Indeed, *these* Petitioners cannot even claim to *have* a rate order. And their effort to impute confiscation to 20th Century's rate order—on the basis that 20th Century was denied a 20% rate of return on its 1989 rates—utterly fails the established test for confiscation.

The petition should be denied.

Respectfully submitted,

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Nos. 94-1119 and 94-1120

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

20TH CENTURY INSURANCE CO., *et al.*,
Petitioners,

v.

JOHN GARAMENDI,
INSURANCE COMMISSIONER, *et al.*,
Respondents.

CENTURY-NATIONAL INSURANCE COMPANY, *et al.*,
Petitioners,

v.

JOHN GARAMENDI,
INSURANCE COMMISSIONER, *et al.*,
Respondents.

On Petitions for Writs of Certiorari to the Supreme Court of California

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BRIEF OF RESPONDENT PREFERRED RISK MUTUAL INSURANCE COMPANY IN SUPPORT OF THE PETITIONS

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TABLE OF CONTENTS

PAGE

TABLE OF AUTHORITIES ii

1. The California Supreme Court's interpretation of the Proposition 103 rollback regulations reflects a profound misunderstanding of the "end results test" of *FPC v. Hope Natural Gas Co.* 3

2. The objectives of the rollback regulations bear no relationship to identification of rates that are not unconstitutionally confiscatory 4

CONCLUSION 8

TABLE OF AUTHORITIES

PAGE

Allied Stores of Ohio v. Bowers, 358 U.S. 522 (1959) (Brennan, J. concurring) 7

Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989) (concurring opinion) 4, 5

FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944) 3

Healy v. Beer Institute, 491 U.S. 324 (1989) 6, 7

Metropolitan Life Ins. Co. v. Ward, 470 U.S. 869 (1985) 7

Wyoming v. Oklahoma, 502 U.S. 437, 112 S.Ct. 789 (1992) 6

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---

BRIEF OF RESPONDENT PREFERRED RISK MUTUAL INSURANCE COMPANY IN SUPPORT OF THE PETITIONS

Respondent Preferred Risk Mutual Insurance Company (Preferred Risk) supports the Petitioners' requests for review of the California Supreme Court's unprecedented application of this Court's "takings" jurisprudence to the actions of the Respondent Commissioner forcing hundreds of insurers doing business in California to disgorge billions of dollars in insurance premiums.

Preferred Risk is a mutual company organized under the laws of the State of Iowa[1] and is licensed to do business in all the States. Preferred Risk's business is balanced between the personal and commercial lines of insurance. It is a "niche" insurer, recognized as one of the nation's premier insurers of churches, church colleges and universities and other church-related operations.

Preferred Risk is one of scores of insurers who joined as petitioners in the *Hartford Steam Boiler* case which was consolidated below with the *20th Century Insurance Co.* case. The California Supreme Court's decision establishes standards governing application of the Respondent Commissioner's regulations implementing the "rollback" obligations imposed on hundreds of insurers by Proposition 103, including Preferred Risk, which faces asserted liabilities amounting to over 7 million dollars.

The courts below were aware that the *20th Century Insurance Co.* case was a test case for the Respondent Commissioner's Proposition 103 rollback regulations and they approached the identification and analysis of the issues raised by the regulations in that context. Consequently, the decisions of these courts will have a preclusive effect on future consideration of those issues in administrative hearings and judicial proceedings involving other insurers.

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[1] Preferred Risk has no parent company. It is affiliated with Midwest Mutual Insurance Company, which has no parent company. Preferred Risk owns 88% of the stock of Preferred Risk Financial, Inc., an insurance holding company. Midwest Mutual owns 9% of the stock of the holding company; the balance of the stock is owned by a Swedish company, Ansvar Mutual General Ins. Co. and miscellaneous employee-owned retirement plans.

1. The California Supreme Court's interpretation of the Proposition 103 rollback regulations reflects a profound misunderstanding of the "end results test" of *FPC v. Hope Natural Gas Co.*

Preferred Risk agrees with Petitioners that the California Supreme Court has erred in interpreting this Court's opinion in *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) as meaning that the return the Commissioner's rollback regulations constitutionally must allow an insurer the opportunity to earn on its rates can be something less than its cost of capital. This error stems from the Court's misunderstanding of the "end result" test adopted by this Court in *Hope* as an alternative to detailed constitutional review of ratemaking methodologies.

The *Hope* Court described a constitutionally acceptable end result as "rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed . . . even though they might produce a meager return on the so-called 'fair value' rate base." 320 U.S. at 605. Contrary to the opinion of the California Supreme Court, it is evident from this language that the *Hope* Court had no intention of abandoning "cost of capital" as an essential element of a minimally nonconfiscatory rate under the cost of service approach to ratemaking. However, not only does the California Supreme Court's misinterpretation of the *Hope* test free the Commissioner to impose confiscatory rollback rates on insurers, the formula approved by the Court for developing such rates virtually guarantees that the confiscatory results of the regulations will impact similarly situated and competing insurers irrationally, arbitrarily and unequally.

2. The objectives of the rollback regulations bear no relationship to identification of rates that are not unconstitutionally confiscatory

The issue presented by the decision below is not the adequacy of a hypothetical return on a synthetic rate base of a public utility. The issue here is the constitutionality of the State of California's attempt to devise a price fixing formula by which to force insurers to disgorge premiums paid them by insureds in the past under competitive market conditions.

Proposition 103 and the Commissioner's rollback regulations represent political judgments that California consumers were being charged too much for insurance and that insurers should not be allowed to retain premiums in excess of the minimum rate constitutionally permissible. Determining what that rate might be for historic periods of an enterprise's operations does not involve the speculation required to approximate a rate for a public utility on a prospective basis, even though all such ratemaking is constrained by the same principles of unconstitutional confiscation.

Catch phrases like "deep financial hardship" or "ability to operate successfully" may be useful for subjectively describing what might constitute a just and reasonable future return for an enterprise enjoying a natural monopoly, but they are worse than meaningless to the task of determining in hindsight what rate would have generated a fair and reasonable return for a company competing in the open market with hundreds of other enterprises.

The California Supreme Court's interpretation of the rollback regulations poses the dilemma alluded to by Mr. Justice Scalia in *Duquesne Light Co. v. Barasch,* 488 U.S. 299, 317 (1989) (concurring opinion):

> [W]hile "prudent investment" (by which I mean capital reasonably expended to meet the utility's legal obligation to assure adequate service) need not be taken into account as such in ratemaking formulas, it may need to be taken into account in assessing the constitutionality of the particular consequences produced by these formulas. We cannot determine whether the payments a utility has been allowed to collect constitute a fair return on investment, and thus whether the government's action is confiscatory, unless we agree on what the relevant "investment" is.

The California opinion leaves no doubt that the rollback regulations are to be applied with complete disregard for, and of, this constitutional predicate. As that Court mandates their application, the rates the regulatory formula will produce will bear no correlation to a "fair", *i.e.* nonconfiscatory, return on an insurer's capital investment because they misidentify the relevant investment.

Insurers encounter a wide range of risks—from underwriting and investment risks to catastrophe and credit risks—not all of which are related to premium volume in any given year. Consequently, premium to surplus ratios can vary widely between insurers writing even the same lines of business. The Commissioner's regulations, however, disregard these wide variations and impute artificial premium/surplus ratios to insurers for the purpose of setting rates. Indeed, some of the artificial ratios assigned insurers by the Commissioner would violate the regulatory requirements of some other State jurisdictions. Iowa, for example, forbids insurers to allow premium/surplus ratios to exceed 3/1 without approval (Iowa Ins. Regs. §191-5.5), which is lower than the artificial ratios attributed by the Commissioner to a number of lines of business of insurers for purposes of the premium rollback.

As explained in the petitions for review, establishing rates for the rollback period in the manner commanded by the California Supreme Court will result in insurance consumers in other States subsidizing insurance consumers in California. This is especially true in the case of mutual companies, whose surplus may be generated principally by profits in other States. A forced return of premiums paid by mutual policyholders in a State with a history of losses would amount to taking property belonging to policyholders of the mutual company in other States. This arbitrary treatment of a multistate insurer's capital and surplus has the potential to severely reduce that insurer's ability to respond to the legitimate needs and requirements of other States' policyholders and insurance regulators.

The solvency and financial regulation of an insurer is a matter primarily under the jurisdiction of the insurer's State of domicile. It is proper in this context therefore to measure the propriety of California's conduct not only by considering the consequences of the regulations within California, but what effect would arise if not one but many States adopted similar legislation. *Wyoming v. Oklahoma,* 502 U.S. 437, 112 S.Ct. 789, 800 (1992); *Healy v. Beer Institute*, 491 U.S. 324, 336 (1989). The rollback regulations infringe upon the rights of California's sister States to regulate insurers by permitting retroactive adjustment of expenses actually incurred by an insurer and superimposing on it an arbitrary premium/surplus ratio. It requires only a moment's reflection to realize the consequences of many States fixing insurance rates at a level insufficient to return an insurer's cost of capital on the rationale that the insurer's total earnings derived from its activities in all States will enable it to continue in business.

Limiting the amount of surplus that can go into the rate base as the Respondent Commissioner seeks to do would reward insurers who leverage their capital to write more and more premiums—a result contrary to what the National Association of Insurance Commissioners is striving to accomplish with its risk-based capital guidelines.[2] An insurer's surplus is available to support all claims and all policyholders at all times and in all locations. The Respondent Commissioner's attempt to allocate insurer surplus for the particular benefit of California policyholders could trigger a "land rush" among regulatory jurisdictions to claim similar advantage for their insurance consumers.

Under our system of constitutional federalism the respect required for the autonomy of the individual States within their respective spheres inherently limits each State's power to fashion economic regulatory schemes. *See Allied Stores of Ohio v. Bowers,* 358 U.S. 522, 532 (1959) (Brennan, J. concurring); *Metropolitan Life Ins. Co. v. Ward,* 470 U.S. 869, 878 (1985); *Healy v. Beer Institute, supra*. As interpreted by the California Supreme Court, the rollback provisions of Proposition 103 and its implementing regulations exceed these limits.

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[2] The National Association of Insurance Commissioners Risk Based Capital Model Act will require (beginning with the 1994 Annual Statement) an insurer to compute the amount of capital to support four broad risk elements encountered by each insurer group: asset risk; credit risk; loss reserve risk and written premium risk. The goal of these regulatory requirements is to help assure the adequate capitalization and solvency of domestic insurers. These requirements are in direct conflict with the arbitrary surplus caps in the Commissioner's regulations.

CONCLUSION

For the reasons stated herein, the petitions for writs of certiorari should be granted.

Respectfully submitted,

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Nos. 94-1119, 94-1120

IN THE
Supreme Court of the United States
OCTOBER TERM, 1994

20TH CENTURY INSURANCE CO., *et al.*,
Petitioners,
v.
CHARLES QUACKENBUSH, Insurance Commissioner, *et al.*,
Respondents.

CENTURY-NATIONAL INSURANCE CO., *et al.*,
Petitioners,
v.
CHARLES QUACKENBUSH, Insurance Commissioner of California, *et al.*,
Respondents.

On Petitions for Writs of Certiorari to the Supreme Court of California

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BRIEF OF RESPONDENT UNITED SERVICES AUTOMOBILE ASSOCIATION

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QUESTION PRESENTED

Did the California Supreme Court err in concluding that a regulated entity is not entitled under the Fifth and Fourteenth Amendments to an opportunity to recover its cost of capital in the rates it is permitted to charge?

PARTIES TO THE PROCEEDING AND RULE 29.1 STATEMENT

Respondents United Services Automobile Association and its subsidiaries, USAA Casualty Insurance Company and USAA General Indemnity Company (hereinafter collectively "USAA") were respondents before the California Supreme Court and plaintiffs before the Superior Court for the County of Los Angeles in *Hartford Steam Boiler Inspection and Ins. Co. v. Garamendi*, No. BC 023983, which was consolidated in part with the actions brought by Petitioners 20th Century Insurance Company and 21st Century Casualty Company in the Superior Court, cases No. SFSC 938470 and No. BS 016289.

Respondent Charles Quackenbush is the Insurance Commissioner of California, substituted for his predecessor John Garamendi pursuant to S. Ct. Rule 35.3. Former Commissioner Garamendi was appellant before the California Supreme Court and defendant before the Superior Court. Respondent Voter Revolt intervened in the Superior Court and was an appellant before the California Supreme Court.

The other parties to these proceedings are listed at No. 94-1119 Pet. ii-iv and No. 94-1120 Pet. ii-iii.

United Services Automobile Association is the parent of, and wholly owns, USAA Casualty Insurance Company and USAA General Indemnity Company. While there are other wholly-owned subsidiaries of United Services Automobile Association, they are not involved in this proceeding, and there are no subsidiaries that are not wholly-owned.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
PARTIES TO THE PROCEEDING AND RULE 29.1 STATEMENT	ii
TABLE OF AUTHORITIES	iv
INTRODUCTION	1
REASONS FOR GRANTING THE WRIT	3
I. THE DECISION OF THE CALIFORNIA SUPREME COURT CONFLICTS WITH THIS COURT'S PRECEDENTS	3
II. CONFLICT AMONG COURTS REGARDING THE LEGAL STANDARD APPLICABLE TO WHETHER REGULATED RATES ARE CONFISCATORY HAS BECOME INTOLERABLE AS A RESULT OF THE DECISION BELOW	5
CONCLUSION	6

TABLE OF AUTHORITIES

Cases Page

Appeal of Public Serv. Co. of New Hampshire, 130 N.H. 748, 547 A.2d 269 (1988) 5
AT&T v. FCC, 836 F.2d 1386 (D.C. Cir. 1988) 5
Guaranty Nat'l Ins. Co. v. Gates, 916 F.2d 508 (9th Cir. 1990) 4, 5
Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944) 2, 3, 5
Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276 (1923) 3
Tennessee Gas Pipeline Co. v. FERC, 926 F.2d 1206 (D.C. Cir. 1991) 5

Constitutional Provisions

U.S. Const. amend. V 2, 6
U.S. Const. amend. XIV 2, 6

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On Petitions for Writs of Certiorari to the Supreme Court of California

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BRIEF OF RESPONDENT UNITED SERVICES AUTOMOBILE ASSOCIATION

INTRODUCTION

United Services Automobile Association and its subsidiaries, USAA Casualty Insurance Company and USAA General Indemnity Company (hereinafter collectively "USAA") were parties before the California Supreme Court in the above-captioned proceeding, and accordingly are respondents under S. Ct. Rule 12.4 in case No. 94-1119 and case No. 94-1120 before this Court. USAA supports the position of the petitioners in these cases, and urges the Court to grant the petitions for certiorari.

USAA is a reciprocal inter-insurance exchange dedicated to serving the insurance needs of active and former military officers, employees of certain federal agencies, and their families. USAA has approximately 2.4 million members nationwide. Selling primarily homeowners and automobile insurance policies, USAA and its subsidiaries constitute the fourth-largest home insurer and fifth-largest private passenger automobile insurer in the United States.

At the outset, USAA notes that it has settled its Proposition 103 "rollback" refund obligation with the California Department of Insurance. USAA nonetheless urges the Court to grant the petitions and review the decision of the California Supreme Court, because the legal standard articulated and applied by the California Supreme Court below departs dramatically from the standard established by this Court in *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), for determining when rate regulation goes too far and becomes a taking of private property without just compensation in violation of the Fifth and Fourteenth Amendments to the Constitution. The question of the appropriate legal standard governing that determination is of course a matter of great and continuing concern to USAA, as it is to any firm subject to ongoing rate regulation. The California Supreme Court's decision exacerbated a growing conflict among the lower courts over the proper understanding of this Court's opinion in *Hope*, a conflict that poses particular problems for insurers like USAA and other regulated entities that do business in different jurisdictions throughout the Nation. This Court should grant the petitions to resolve this conflict and ensure a uniform understanding of the federal constitutional limits on rate regulation throughout the United States.

REASONS FOR GRANTING THE WRIT

I. THE DECISION OF THE CALIFORNIA SUPREME COURT CONFLICTS WITH THIS COURT'S PRECEDENTS.

Although USAA has settled its particular "rollback" liability under Proposition 103, the legal standard announced by the California Supreme Court for deciding when rates are confiscatory has significance far beyond the particular factual context that gave rise to the decision below. That decision should be reviewed by this Court because the analysis and holding of the California Supreme Court plainly departed from the constitutional framework established by this Court.

This Court's opinions have long recognized the requirement that a regulated firm be allowed an opportunity to earn a return sufficient to cover its reasonable cost of capital. *See Hope*, 320 U.S. at 603; *Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 291 (1923) (opinion of Brandeis, J., joined by Holmes, J.). If a firm is not permitted to recover its cost of capital, the firm's capital is in effect being used by the public without payment, in violation of the takings clause. The fundamental error in the decision below is that the court divorced its understanding of a reasonable rate of return from the cost of capital.

This Court in *Hope* said that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks," 320 U.S. at 603—the common definition of the cost of capital. The California Supreme Court, however, transformed this standard of what the return "should be" under the Fourteenth Amendment into "an interest that the producer may pursue and not a right that it can demand." 94-1119 Pet. App. 79a; *see id.* at 84a, 85a-86a, 116a, 123a. Thus, the court converted what was a constitutional floor in *Hope* to merely an "interest" that can be balanced against other interests, so that what had been

understood to be a property right protected against uncompensated takings became simply a procedural right to a certain degree of consideration by the regulator.

In place of a return "commensurate with returns on investments in other enterprises having corresponding risks," the court below promised only protection against "deep financial hardship"—a standard not met so long as a firm can be said "to operate successfully," which the court below defined as meaning no more than covering "out-of-pocket" costs. *See* 94-1119 Pet. App. 79a-80a & n.18. Indeed, the California Supreme Court expressly noted its disagreement with the Ninth Circuit's decision in *Guaranty Nat'l Ins. Co. v. Gates*, 916 F.2d 508 (9th Cir. 1990), precisely because the *Gates* court held that a firm was entitled to recover more than its out-of-pocket costs. *See* 94-1119 Pet. App. 79a n.18.

The court below treated 20th Century's challenge to its rollback liability as a "test case." *Id.* at 34a. It disposed of that challenge by articulating a new constitutional standard that did not require affording the regulated firm the opportunity to recover its cost of capital, but instead required only that the firm not be driven into "deep financial hardship." 20th Century lost its case not because the California Supreme Court decided that the rates it was permitted to charge allowed it to recover its reasonable cost of capital, but because the court believed 20th Century could refund to policyholders what the Insurance Commissioner demanded without experiencing "deep financial hardship." The case was not decided on the basis of the particular facts of 20th Century's rate of return or cost of capital, but in light of the new legal standard articulated by the court below. The decision therefore has broad significance beyond the particular facts of 20th Century's situation, and cannot be limited to those facts. That is why USAA urges this Court to grant the petitions and review the new legal standard announced by the court below.

II. CONFLICT AMONG COURTS REGARDING THE LEGAL STANDARD APPLICABLE TO WHETHER REGULATED RATES ARE CONFISCATORY HAS BECOME INTOLERABLE AS A RESULT OF THE DECISION BELOW.

Given the sharp departure of the court below from the standard established by this Court in *Hope*, it should come as no surprise that the ruling below conflicts with decisions of other state supreme courts and federal courts of appeals. Those courts have held in unambiguous terms that a regulated firm is entitled to an opportunity to earn a rate of return equal to its reasonable cost of capital. *See, e.g., Guaranty Nat'l Ins. Co. v. Gates*, 916 F.2d 508 (9th Cir. 1990); *Tennessee Gas Pipeline Co. v. FERC*, 926 F.2d 1206 (D.C. Cir. 1991); *AT&T v. FCC*, 836 F.2d 1386, 1389-90 (D.C. Cir. 1988); *Appeal of Public Serv. Co. of New Hampshire*, 130 N.H. 748, 547 A.2d 269 (1988).

Before the California Supreme Court, the Insurance Commissioner himself acknowledged that "it is not clear what showing is required to establish confiscation." Comm'r Opening Br. at 60. That uncertainty and confusion has been greatly exacerbated by the decision below. The resulting variety of "confiscation" standards affects multistate insurers and their policyholders due to inevitable cross-subsidies and other extraterritorial effects. For example, the military officers who, with their families, form the core of USAA's policyholders, move regularly among military bases in the United States and overseas. To serve them adequately, USAA must be able to provide insurance wherever these officers are assigned, including California. Yet it will be difficult to justify to non-California policyholders the continuation of California coverage if no return is permitted on the substantial capital at risk in California. Multistate insurers, including USAA, may be faced with a Hobson's choice between breaking relationships with policyholders while they are in California or weakening the security of all other policy-

holders by continuing to operate in California without a return on the capital at risk.

The question presented by the petitioners is an important one even for a party below like USAA that has settled its "rollback" refund, due to the application of the legal standard below to future regulation in California and the conflicting standards in states other than California. The question is also important for its obvious impact on regulated industries other than insurance. Those industries are subject to the same constitutional standard for confiscation under the Fifth and Fourteenth Amendments, and that standard ought to be uniform among the various states that regulate those industries.

CONCLUSION

For the foregoing reasons this Court should grant the writ and reverse the decision below.

Respectfully submitted,

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On Petition for a Writ of Certiorari to the Supreme Court of California

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BRIEF *AMICI CURIAE* OF THE AMERICAN INSURANCE ASSOCIATION, THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS, AND THE ALLIANCE OF AMERICAN INSURERS IN SUPPORT OF PETITIONERS

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24 pp

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES..... ii

INTEREST OF *AMICI CURIAE* 1

SUMMARY OF ARGUMENT 2

REASONS FOR GRANTING THE PETITION 4

A. Loss Of The Opportunity To Recover Cost Of Capital Undermines The Financial Stability Of Insurance Companies And The Security That Policyholders Purchase .. 4

B. The California Supreme Court's Rate Regulation Takings Standard Threatens To Entice Other States To A Race To The Bottom 10

CONCLUSION 14

TABLE OF AUTHORITIES

Cases	Page(s)
Dolan v. City of Tigard, 114 S. Ct. 2309 (1994)	4
Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989)	6,12
Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944)	4,12,13
Guaranty Nat'l Ins. Co. v. *Gates*, 916 F.2d 508 (9th Cir. 1990)	14
Jersey Central Power & Light Co. v. *FERC*, 810 F.2d 1168 (D.C. Cir. 1987) (*en banc*)	3,9,13
Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276 (1923)	5,13
Yee v. *Escondido*, 112 S. Ct. 1522 (1992)	14
Statutes:	
Ala. Code §§ 27-13-30, 27-13-1 (1994)	6
Alaska Stat. §§ 21.39.040, 21.39.030 (1994)	6
Ariz. Rev. Stat. Ann. §§ 20-385, 20-341 (West 1994)	6
Ark. Code Ann. §§ 23-67-211, 23-67-213 (Michie 1994)	6
Cal. Ins. Code § 1861.05(a) (West 1994)	10
Colo. Rev. Stat. Ann. §§ 10-4-401, 10-1-101, 10-1-108 (West 1994)	6
Conn. Gen. Stat. Ann. §§ 38a-676, 38A-688, 38a-208 (West 1993)	6

Del. Code Ann. tit. 18, §§ 2501, 2503, 2504, 2605 (1994) 6

D.C. Code Ann. §§ 35-1703, 35-1704 (1994) 6

Fla. Stat. Ann. §§ 627.062 (West 1994) 7

Ga. Code Ann. §§ 33-9-21, 33-9-1, 33-9-4 (1994) 7

Haw. Rev. Stat. Ann. §§ 431:14-104, 431:14-103 (Michie 1994) 6

Idaho Code § 41-1402 (Michie 1994) 7

Ill. Rev. Stat. ch. 215, § 456 (West 1994) 7

Ind. Code Ann. §§ 27-1-22-4, 27-1-22-1, 27-1-22-3 (West 1994) 7

Iowa Code Ann. §§ 515F.5, 515F.24 (West 1993) ... 7

Kan. Stat. Ann. § 40-1113 (1993) 6

Ky. Rev. Stat. Ann. §§ 304.13-051, 304.13-031 (Michie 1994) 7

La. Rev. Stat. Ann. §§ 22:1404, 22:1407, 22:1402 (West 1993) 6

Me. Rev. Stat. Ann. tit. 24-A, §§ 2304-A, 2301, 2303 (West 1994) 7

Md. Code Ann., Ins. § 242 (Michie 1994) 6

Mass. Gen. L. Ann. ch. 174A , §§ 5, 6, ch. 175A, § 6 (West 1994) 6

Mich. Comp. Laws Ann. §§ 500.2406, 500.2420 (West 1994) 6

Minn. Stat. Ann. § 70A.06 (West 1994) 7

Miss. Code Ann. §§ 83-2-7, 83-2-3 (1993) 6

Mo. Ann. Stat. §§ 379.321, 379.318 (Vernon 1993) 7

Mont. Code Ann. §§ 33-16-203, 33-16-234, 33-16-101 (1993) 7

Neb. Rev. Stat. § 44-5020, 44-5002 (1994) 6

Nev. Rev. Stat. §§ 686B.110, 686B.050 (1993) 6

N.H. Rev. Stat. Ann. §§ 414:4, 414:1 (1993) 7

N.J. Stat. Ann. §§ 17:29A-6, 17:29A-7, 17:29A-10 (West 1994) 6

N.Y. Ins. Law §§ 2321, 2305 (McKinney 1994) 7

N.M. Stat. Ann. §§ 59A-17-9, 59A-17-3, 59A-17-6 (Michie 1994) 6

N.C. Gen. Stat. §§ 58-36-15, 58-36-10 (Michie 1994) 7

N.D. Cent. Code §§ 26.1-25-04, 26.1-25-01, 26.1-25-03 (Michie 1993) 6

Ohio Rev. Code Ann. §§ 3935.04, 3935.03 (Anderson 1992) 6

Okla. Stat. Ann. tit. 36, §§ 903, 901.1, 902 (West 1994) 6

Or. Rev. Stat. §§ 737.207, 737.025, 737.310 (1993) 7

40 Pa. Cons. Stat. Ann. §§ 1184, 1181, 1183 (West 1994) 6

P.R. Laws Ann. tit. 26, §§ 1205, 1206, 1201, 1204 (1990) 6

R.I. Gen. Laws Ann. §§ 27-6-8, 27-6-1, 27-6-4 (Michie 1993) 6

S.C. Code Ann. §§ 38-73-960, 38-73-10 (Law Co-op. 1993) 6

S.D. Codified Laws §§ 58-24-10, 58-24-15, 58-24-16, 58-24-1, 58-24-5, 58-24-6 (1994) 6

Tenn. Code Ann. §§ 56-5-305, 56-5-306, 56-5-303 (1994) 7

Tex. Ins. Code Ann. § 5.13-2 (West 1994) 7

Utah Code Ann. §§ 31A-19-101, 31A-19-201, 31A-19-203 (1994) 7

Vt. Stat. Ann. tit. 8, §§ 4688, 4689 (1993) 7

V.I. Code Ann. tit. 22, §§ 53A, 1491 (1994) 7

Va. Code Ann. § 38.2-2008, 38.2-1904 (Michie 1994) 7

Wash. Rev. Code Ann. §§ 48.19.060, 48.19.020 (West 1993) 6

W. Va. Code §§ 33-20-4, 33-20-1, 33-20-3 (Michie 1994) 6

Wisc. Stat. Ann. §§ 625.13, 625.01, 625.11 (West 1994) 6

Wyo. Stat. §§ 26-14-107, 26-14-108, 26-14-101 (1994) 7

Other Authorities:

Richard A. Brealey & Stewart C. Myers, *Principles of Corporate Finance* (4th ed. 1991) 6

INTEREST OF *AMICI CURIAE*

The American Insurance Association ("AIA") is a national trade association, with headquarters in Washington, D.C., representing more than 270 property and casualty insurance companies in the United States. In 1993, AIA member companies wrote $53 billion in insurance premiums, $5.7 billion in California.

The National Association of Independent Insurers ("NAII") is a national trade association, with headquarters in Des Plaines, Illinois, representing more than 570 property and casualty insurance companies in the United States. In 1993, NAII member companies wrote over $62 billion in insurance premiums, $7 billion in California.

The Alliance of American Insurers ("AAI") is a national trade association, with headquarters in Schaumburg, Illinois, representing more than 220 property and casualty insurance companies in the United States. In 1993, AAI member companies wrote $19 billion in insurance premiums, $1.3 billion in California.

Together, AIA, NAII, and AAI member companies constitute more than 60 percent of the market of the nation's property and casualty insurance.

Many AIA, NAII, and AAI member companies are subject to California insurance rate regulation. Following the California Supreme Court's decision in this case, California Insurance Commissioner Garamendi ordered 28 insurance companies to pay Proposition 103 rollbacks totaling $1.25 billion. *See* Appendix to this Brief. The Commissioner ordered at

least $900 million of these payments from AIA, NAII, and AAI member companies.

AIA, NAII, and AAI member companies also sell insurance in every other state that regulates insurance rates. AIA, NAII, and AAI file this brief *amici curiae* because of their interest in preventing the State of California from taking the property of member companies through confiscatory maximum premium rates. *Amici* also are legitimately concerned that other states may join California in a race to the bottom, adopting the same erroneous constitutional standard and establishing maximum premium rates that threaten the survival of insurance companies.*

SUMMARY OF ARGUMENT

This is a case of extraordinary importance for insurance companies and policyholders nationwide. The effect of a state-regulated rate that precludes a company from recovering its cost of capital is more than just a cost of doing business in a regulated environment; recovery of the cost of capital is necessary to the continuing viability of any business. Denial of the cost of capital by government action is confiscation.

The cost of capital describes the rate of return a business must produce to attract capital in a competitive market. If a business is not expected to produce a rate of return at least comparable to that available from other

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* Counsel to the parties have consented to the filing of this brief. *Amici* have filed letters of consent with the Clerk.

investments with similar risk, capital will flow away from that business into superior investments. An insurance company's primary capital is the funds that stand behind its ability to pay claims and meet the demands of unexpected events. An insurance company guaranteed not to make its cost of capital will begin a downward spiral of lost capital that will increase the riskiness of the firm and threaten its financial integrity.

This decline in capital imposes heavy costs on policyholders because the insurance company's ability to handle future losses is diminished. Policyholders lose the security they have purchased with insurance.

The California Supreme Court announced its constitutional rule in part as an interpretation of a state statute that prohibits "excessive, inadequate or unfairly discriminatory" insurance rates. Every other state imposes a similar statutory requirement. Thus, every other state has an opportunity to follow California's lead and establish rates within their current statutory schemes that prevent insurance companies from recovering their cost of capital.

The California Supreme Court has set the new floor for insurance ratemaking, in part through a gross misreading of the phrase "deep financial hardship" in *Jersey Central Power & Light Co.* v. *FERC*, 810 F.2d 1168 (D.C. Cir. 1987) (*en banc*). It is plain from the language of that opinion and from this Court's decisions that a taking occurs well before a regulated entity is in deep trouble. The reinterpretation of *Jersey Central* by a bellwether state supreme court is likely to exert a significant influence on other courts and regulators, particularly when it may be in their interest to agree

with the California court. The resulting race to the bottom will produce confiscation nationwide.

REASONS FOR GRANTING THE PETITION

Last Term, this Court found it necessary to reaffirm that property rights are entitled to as much protection as other rights enumerated in the Constitution: "We see no reason why the Takings Clause of the Fifth Amendment, as much a part of the Bill of Rights as the First Amendment or Fourth Amendment, should be relegated to the status of a poor relation . . . ." *Dolan v. City of Tigard*, 114 S. Ct. 2309, 2320 (1994). The California Supreme Court's decision in the present case is a striking example of a court not taking property rights seriously. That court held that state rate regulators could ignore the cost of capital, critical to the long-term survival of any firm, as long as the regulated rate did not promise immediately to plunge a firm into "deep financial hardship." Pet. App. 82a. This draconian standard promises profound adverse consequences for insurance companies and their policyholders in California and nationwide. A full understanding of these consequences establishes this as a case of extraordinary importance. *Amici* urge this Court to set this case for plenary review and reverse the decision below.

A. Loss Of The Opportunity To Recover Cost Of Capital Undermines The Financial Stability Of Insurance Companies And The Security That Policyholders Purchase

For the California Supreme Court, the cost of capital is merely an "interest" that insurance companies might pursue rather than a necessary element of a nonconfiscatory regulated rate. Pet. App. 79a. The

court concluded that state regulators need not consider the cost of capital in setting insurance rates. This constitutional error ignores the full importance of cost of capital.

The effect of a state-regulated rate that precludes a company from recovering its cost of capital is more than just a cost of doing business in a regulated environment. Such regulation goes beyond a diminution in profits; recovery of the cost of capital is necessary to the continuing viability of any business. For this reason, a regulated rate that guarantees that a business will not be able to recover its cost of capital is a taking:

> The compensation which the Constitution guarantees an opportunity to earn is the reasonable cost of conducting the business. Cost includes not only operating expenses, but also capital charges. Capital charges cover the allowance, by way of interest, for the use of capital, whatever the nature of the security issued therefor; the allowance for risk incurred; and enough more to attract capital.

Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 291 (1923) (Brandeis, J., concurring). Accord *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). The opportunity to recover cost of capital is more than a business "interest," it is part of the Fifth Amendment's minimum constitutional guarantee. A state cannot prevent a legitimate enterprise from attempting to stay in business.

Without the opportunity to recover its cost of capital, no business can do so.[1]

An insurance company, like any other business, is an investment. Those who supply capital to the firm do so with the expectation that they will receive a return on their investment. There is a market for such capital. The decision to invest capital in any particular business will be based on the expected rate of return and the risk involved.

The cost of capital describes the rate of return a business must produce to attract capital in a competitive market: The cost of capital, sometimes called the "opportunity cost of capital," is the expected rate of return available from other investments with comparable risk. Richard A. Brealey & Stewart C. Myers, *Principles of Corporate Finance* 13 (4th ed. 1991). See also *Hope*, 320 U.S. at 603 ("the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks"). It is an opportunity cost because the cost of capital is the opportunity foregone by investing in one investment rather than another. If a business is not expected to produce a rate of return at least comparable to that available from other investments with similar

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[1] Contrary to the Commissioner's contention, the argument here is not that insurance companies have a constitutional right to achieve a certain level of profit, or even a right to stay in business. See Opp. in No. 94-1119 at 17-19. But insurance companies, like any other legitimate enterprise, have a right to *attempt to* stay in business. A regulated rate that guarantees that a firm will be unable to recover a necessary cost of doing business is a taking. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 312 (1989).

risk, capital will flow away from that business into superior investments.

It is not enough that a business make a profit; the rate of return must be sufficiently high to warrant the risk that capital investors face or they will put their money elsewhere. The riskier the business, the higher the rate of return the business must produce to attract capital.

Insurance is by definition a risky business; future uncertain events are an insurance company's stock in trade. Insurance companies, particularly smaller companies like petitioner 20th Century, must make a profit comparable to other risky investments. Commissioner Garamendi contends that he set rates for insurance companies based on a 10 percent rate of return.[2] Pet. App. 186a. Petitioners demonstrated that the actual rate of return is significantly lower. Pet. in

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[2] The Commissioner derived the 10 percent figure from historical rates of return for the insurance industry. Pet. App. 188a-190a. The cost of capital bears no necessary relation to a business's historical rate of return. Historical rate of return is a measure of how a company has done in the past; the cost of capital is a measure of how well the company will need to do in the future. Yet the Commissioner and the California Supreme Court imply that an insurance premium rate is constitutional if it allows each company a rate of return comparable to historical averages for the industry as a whole. This is error, first because the cost of capital may vary widely between insurance companies depending on their riskiness; premium rates based on industry average rates of return ignore these differences. Second, historical rates of return do not establish the rate of return a company will need in the future. A regulated rate that guarantees failure by precluding a company from setting prices high enough to allow it to stay in business is a taking.

No. 94-1119 at 17-18.[3] But even a rate of return limited by government regulation to 10 percent is plainly insufficient in a market (in 1989) where investors could earn over 8 percent by investing in risk-free government securities. An insurance investor faces the significant risk of losing capital to future unforeseen events against which the company has insured, and must be compensated accordingly. The cost of capital takes into account the riskiness of the business. The Commissioner's rates, and the regulatory scheme the California Supreme Court approved, ignores risk and ignores the certainty that investors will move capital into safer investments or into investments of comparable risk with a higher rate of return.

An insurance company's primary capital is the funds that stand behind its ability to pay claims and meet the demands of unexpected events. When catastrophes occur, claims must be paid from this surplus. Petitioner 20th Century Insurance, for example, lost 92 percent of its capital as a result of losses from the 1994 Northridge earthquake. The insurance company must replace that capital if it is to continue to operate and support its policyholders. But if a state has mandated that a company cannot charge rates sufficient to cover the cost of capital, new capital may not be forthcoming.

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[3] The unfairness of the 10 percent rate is manifest in the fact that the Commissioner promulgated the rollback regulations two years after the rollback period, and then did not allow insurance companies to recognize legitimately incurred business expenses. See Pet. App. 184a n.30.

Even in the absence of unforeseen disasters, a company unable to recover its cost of capital eventually will find its capital going elsewhere. Mutual companies, which pay out profits in the form of dividends to policyholders, will lose policies. Stock companies that cannot cover their cost of capital will see the value of their stock drop, making it far more difficult to raise capital through loans and the issuance of new securities. A company guaranteed not to make its cost of capital will begin a downward spiral of lost capital that will significantly impair the firm.[4]

The decline in capital that results from a confiscatory regulated rate imposes heavy costs on policyholders as well as on the owners of insurance companies. When an insurance company loses its surplus capital, its ability to handle future losses is diminished. The enterprise becomes riskier for policyholders, both in California and in every other state in which the company writes policies.[5] In the insurance industry, this is fatal risk, for

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[4] A regulated rate that prevents a firm from recovering cost of capital is a taking, however, long before the firm is driven to bankruptcy. A firm that cannot recover its cost of capital, by that fact alone, suffers "the sort of deep financial hardship described in *Hope*." *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1181 n.3 (D.C. Cir. 1987) (*en banc*).

[5] The California Supreme Court's disregard for policyholders in other states appears extraordinarily broad. The most natural reading of the court's "deep financial hardship" standard is that it focuses on the financial status of the insurance company *as a whole*. Under this standard, as long as a company is able to collect enough premiums from policyholders in other states to avoid "deep financial hardship," California would be permitted to reduce the maximum allowable rates for its citizens as far as it desires--even to 0--without violating the Takings Clause.

the stability of the firm and its ability to stand behind its policies is the "rock" that policyholders purchase. What is taken in such a case is not only the property of the insurance company, but the security of policyholders.

B. The California Supreme Court's Rate Regulation Takings Standard Threatens To Entice Other States To A Race To The Bottom

The California Supreme Court announced its rule that the Constitution does not require consideration of cost of capital in the context of a state statute that establishes limits on insurance rate regulation. A key component of Proposition 103 recites:

> No rate shall be approved or remain in effect which is excessive, inadequate [or] unfairly discriminatory . . . .

Cal. Ins. Code § 1861.05(a) (West 1994). The California court made clear repeatedly that the minimum rates allowed under the statute in this case are coextensive with the constitutional minimum under the Takings Clause: "Under the rate rollback requirement provision--to use the terms appearing in Insurance Code § 1861.05, subdivision (a)--a rate is 'inadequate' if confiscatory and 'excessive' if more than minimally nonconfiscatory and above 80 percent of the 1987 rate." *E.g.*, Pet. App. 26a; *id.* 10a-11a; *id.* 68a. The "inadequate" standard of § 1861.05(a) does nothing more than prohibit "maintenance of confiscatory rates." *Id.* at 9a (internal quotations omitted). And nonconfiscatory rates, according to the California Supreme Court, need not allow insurance companies an opportunity to recover their cost of capital.

This decision threatens a wide and unfortunate effect, for California is not alone in prohibiting "excessive" and "inadequate" insurance rates. The insurance code of *every* state (and the District of Columbia, Puerto Rico, and the Virgin Islands) provides that insurance rates shall not be "excessive, inadequate, or unfairly discriminatory."[6] Thus, every other state

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[6] At least twenty-seven states in addition to California have "prior approval" systems for setting insurance rates and use an "excessive, inadequate or unfairly discriminatory" standard for rate-setting. See, e.g., Ala. Code §§ 27-13-30, 27-13-1 (1994); Alaska Stat. §§ 21.39.040, 21.39.030 (1994); Ark. Code Ann. §§ 23-67-211, 23-67-213 (Michie 1994); Del. Code Ann. tit. 18 §§ 2501, 2503, 2504, 2605 (1994); D.C. Code Ann. §§ 35-1703, 35-1704 (1994); Haw. Rev. Stat. Ann. §§ 431:14-104, 431:14-103 (Michie 1994); Kan. Stat. Ann. § 40-1113 (1993); La. Rev. Stat. Ann. §§ 22:1404, 22:1407, 22:1402 (West 1993); Md. Code Ann., Ins. § 242 (Michie 1994); Mass. Gen. L. Ann. ch. 174A, §§ 5, 6, ch. 175A , § 6 (West 1994); Mich. Comp. Laws Ann. §§ 500.2406, 500.2420 (West 1994); Miss. Code Ann. §§ 83-2-7, 83-2-3 (1993); Neb. Rev. Stat. § 44-5020, 44-5002 (1994); Nev. Rev. Stat. §§ 686B.110, 686B.050 (1993); N.J. Stat. Ann. §§ 17:29A-6, 17:29A-7, 17:29A-10 (West 1994); N.M. Stat. Ann. §§ 59A-17-9, 59A-17-3, 59A-17-6 (Michie 1994); N.D. Cent. Code §§ 26.1-25-04, 26.1-25-01, 26.1-25-03 (Michie 1993); Ohio Rev. Code Ann. §§ 3935.04, 3935.03 (Anderson 1992); Okla. Stat. Ann. tit. 36, §§ 903, 901.1, 902 (West 1994); 40 Pa. Cons. Stat. Ann. §§ 1184, 1181, 1183 (West 1994); P.R. Laws Ann. tit. 26, §§ 1205, 1206, 1201, 1204 (1990); R.I. Gen. Laws Ann. §§ 27-6-8, 27-6-1, 27-6-4 (Michie 1993); S.C. Code Ann. §§ 38-73-960, 38-73-10 (Law Co-op. 1993); S.D. Codified Laws §§ 58-24-10, 58-24-15, 58-24-16, 58-24-1, 58-24-5, 58-24-6 (1994); Wash. Rev. Code Ann. §§ 48.19.060, 48.19.020 (West 1993); W. Va. Code §§ 33-20-4, 33-20-1, 33-20-3 (Michie 1994); Wisc. Stat. Ann. §§ 626.13, 625.01, 625.11 (West 1994).

Every other state imposes some sort of system for reviewing and regulating insurance rates, and these States employ the same language to set the limits of permissible rates. See, e.g., Ariz. Rev. Stat. Ann. §§ 20-385, 20-341 (West 1994); Colo. Rev. Stat. Ann. §§ 10-4-401, 10-1-101, 10-1-108 (West 1994); Conn. Gen. Stat.

may have an opportunity to follow California's erroneous lead and establish rates within their current statutory schemes that prevent insurance companies from recovering their cost of capital.

State insurance regulators have a strong incentive to reduce insurance rates down to the constitutional minimum. The California Supreme Court, through its misapplication of the Takings Clause in this case, has established a new floor. Any resulting race to the bottom will produce confiscation nationwide.

The California Supreme Court has made it easier for courts and regulators in other states to establish this new constitutional standard by misinterpreting relevant authority. The California court essentially ignored this Court's decisions in *Hope* and *Duquesne*--and the

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Ann. §§ 38a-676, 38A-688, 38a-208 (West 1993); Fla. Stat. Ann. §§ 627.062 (West 1994); Ga. Code Ann. §§ 33-9-21, 33-9-1, 33-9-4 (1994); Idaho Code § 41-1402 (Michie 1994); Ill. Rev. Stat. ch. 215, § 456 (West 1994); Ind. Code Ann. §§ 27-1-22-4, 27-1-22-1, 27-1-22-3 (West 1994); Iowa Code Ann. §§ 515F.5, 515F.24 (West 1993); Ky. Rev. Stat. Ann. §§ 304.13-051, 304.13-031 (Michie 1994); Me. Rev. Stat. Ann. tit. 24-A, §§ 2304-A, 2301, 2303 (West 1994); Minn. Stat. Ann. § 70A.06 (West 1994); Mo. Ann. Stat. §§ 379.321 379.318 (Vernon 1993); Mont. Code Ann. §§ 33-16-203, 33-16-234, 33-16-101 (1993); N.H. Rev. Stat. Ann. §§ 414:4, 414:1 (1993); N.Y. Ins. Law §§ 2321, 2305 (McKinney 1994); N.C. Gen. Stat. §§ 58-36-15, 58-36-10 (Michie 1994); Or. Rev. Stat. §§ 737.207, 737.025, 737.310 (1993); Tenn. Code Ann. §§ 56-5-305, 56-5-306, 56-5-303 (1994); Tex. Ins. Code Ann. § 5.13-2 (West 1994); Utah Code Ann. §§ 31A-19-101, 31A-19-201, 31A-19-203 (1994); Vt. Stat. Ann. tit. 8, §§ 4688, 4689 (1993); V.I. Code Ann. tit. 22, §§ 53A, 1491 (1994); Va. Code Ann. §§ 38.2-2008, 38.2-1904 (Michie 1994); Wyo. Stat. §§ 26-14-107, 26-14-108, 26-14-101 (1994).

concurrence in *Southwestern Bell* on which they are based--which establish that the "Constitution guarantees" the opportunity to recover cost of capital. See *Southwestern Bell*, 262 U.S. at 291 (Brandeis, J., concurring). Instead, the California Supreme Court derived its standard principally from a gross misreading of the phrase "deep financial hardship" in *Jersey Central Power & Light Co.* v. *FERC*, 810 F.2d 1168 (D.C. Cir. 1987) (*en banc*). That decision expressly recites that a taking occurs when a regulated rate produces "the sort of deep financial hardship described in *Hope*." *Id.* at 1181 n.3. *Hope* explains that a taking occurs when a regulated firm is not allowed to recover its cost of capital. "Deep financial hardship" was perhaps an unfortunate choice of words in *Jersey Central*, but it is plain from the language of that opinion and, more importantly, from this Court's decisions, that a taking occurs well before a regulated entity reaches the precipice of bankruptcy.

The conflict between *Jersey Central* and the California Supreme Court's decision in this case is especially troubling because *Jersey Central* is an *en banc* decision from the premier federal court of appeals on rate-setting issues. The reinterpretation of *Jersey Central* by a bellwether state supreme court is likely to exert a significant influence on other courts and regulators, particularly when it may be in their interest to agree with the California court. This Court should

grant review to eliminate this conflict and avoid the race to the bottom.[7]

CONCLUSION

For the foregoing reasons, the Court should grant the petitions for writ of certiorari and set the case for plenary review.

January 25, 1995

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[7] The California Supreme Court's decision also conflicts expressly with the Ninth Circuit's decision in *Guaranty Nat'l Ins. Co.* v. *Gates*, 916 F.2d 508 (9th Cir. 1990). The Ninth Circuit declared that a regulated entity must be allowed to do more than "break even." *Id.* at 515. The California Supreme Court held that a regulated firm "has no constitutional right to a profit . . ., [i]ndeed, such a firm has no constitutional right even against a loss." Pet. App. 79a. This conflict between two courts whose jurisdiction includes California is sufficient reason to grant certiorari. See *Yee* v. *Escondido*, 112 S. Ct. 1522, 1534 (1992).

APPENDIX

PROPOSITION 103 ROLLBACK ORDERS
NOVEMBER 22, 1994

Insurance Commissioner John Garamendi

	NAME OF GROUP/COMPANY	1989 MARKET SHARE	REFUND AMOUNT	INTEREST from 5/8/89 to 7/1/95	TOTAL: REFUND AMOUNT + INTEREST
1.	FIREMAN'S FUND GROUP	3.1126%	$100,246,125	$61,658,223	$161,904,358
2.	CHUBB & SON INC.	1.7260%	$86,012,117	$52,903,343	$138,915,460
3.	HARTFORD FIRE & CASUALTY	1.6931%	$94,835,870	$58,330,556	$153,166,426

	NAME OF GROUP/COMPANY	1989 MARKET SHARE	REFUND AMOUNT	INTEREST from 5/8/89 to 7/1/95	TOTAL: REFUND AMOUNT + INTEREST
4.	NATIONWIDE CORP.	1.6744%	$57,788,630	$35,543,965	$93,332,595
5.	OHIO CASUALTY GROUP	1.0845%	$38,248,657	$23,525,544	$61,774,201
6.	LIBERTY MUTUAL GROUP	0.9629%	$3,903,883	$2,401,155	$6,305,038
7.	HOME INS. GRP. OF NEW YORK	0.8595%	$40,780,487	$25,082,792	$65,863,279
8.	TRAVELERS INS. COS.	0.8481%	$18,843,270	$11,589,901	$30,433,171
9.	RELIANCE GROUP INC.	0.8442%	$44,751,102	$27,524,993	$72,276,095
10.	MARYLAND CASUALTY COMPANIES	0.7657%	$1,122,906	$690,664	$1,813,570
11.	AMERICAN FINANCIAL INS. GRP.	0.6748%	$45,475,786	$27,970,723	$73,446,509
12.	GOLDEN EAGLE INSURANCE CO.	0.6552%	$15,378,274	$9,458,692	$24,836,966
13.	CENTURY NATIONAL INS. CO.	0.5574%	$23,346,825	$14,359,896	$37,706,721
14.	COLONIAL PENN GROUP	0.4756%	$35,275,315	$21,696,735	$56,972,050
15.	ZURICH-AMERICAN INS. COS.	0.4437%	$26,722,095	$16,435,919	$43,158,014
16.	US FIDELITY & GUARNATY GROUP	0.4322%	$18,500,538	$11,379,098	$29,879,635
17.	ALLIED GROUP (includes Western Heritage Ins. Co.)	0.4217%	$16,558,633	$10,184,694	$26,743,327

	NAME OF GROUP/COMPANY	1989 MARKET SHARE	REFUND AMOUNT	INTEREST from 5/8/89 to 7/1/95	TOTAL: REFUND AMOUNT + INTEREST
18.	REPUBLIC FINANCIAL SERVICES (Winterthur U.S. Holding Group)	0.3873%	$19,911,324	$12,246,828	$32,158,152
19.	ATLANTIC COMPANIES	0.3550%	$10,824,179	$6,657,612	$17,481,791
20.	CALIFORNIA INSURANCE GROUP	0.3454%	$9,933,624	$6,109,859	$16,043,483
21.	UNITRIN GROUP	0.3356%	$11,570,280	$7,116,515	$18,686,795
22.	LAWYERS MUTUAL INS. CO.	0.2593%	$18,186,479	$11,185,930	$29,372,409
23.	UNIVERSAL UNDERWRITERS INS. GRP.	0.2651%	$ 3,026,112	$1,861,266	$4,887,378
24.	GENERAL ACCIDENT INS. GRP.	0.2358%	$10,819,767	$6,654,898	$17,474,665
25.	CLARENDON INS. GROUP	0.2328%	$4,140,383	$2,546,619	$6,687,002
26.	TOPA EQUITIES LIMITED	0.2168%	$6,045,786	$3,718,572	$9,764,358
27.	ALLIANZ INSURANCE GROUP	0.2130%	$4,231,575	$2,602,709	$6,834,284
28.	ALLENDALE GROUP	0.2123%	$10,132,320	$6,232,071	$16,364,391
	TOTALS	20.2900%	$776,612,342	$477,669,782	$1,254,282,124

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No. 94-1120

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OCTOBER TERM, 1994

CENTURY-NATIONAL INSURANCE CO., *et al.*,
Petitioners,

v.

CHARLES QUACKENBUSH,
Insurance Commissioner of California, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the Supreme Court of California

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11 pp

TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	ii
CONCLUSION	8

TABLE OF AUTHORITIES

Cases — Page

Agins v. Tiburon, 447 U.S. 255 (1980) 3
FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944) ..... *passim*
First English Evangelical Lutheran Church v. Los Angeles, 482 U.S. 304 (1987) 8
Kaiser Aetna v. United States, 444 U.S. 164 (1979) 3
Keystone Bituminous Coal Ass'n v. DeBenedictis, 480 U.S. 470 (1987) 3
New Orleans Pub. Serv., Inc. v. Council of New Orleans, 491 U.S. 350 (1989) 3
Pacific Gas & Elec. Co. v. State Energy Resources Conserv. & Dev. Comm'n, 461 U.S. 190 (1983) 3
Pennell v. San Jose, 485 U.S. 1 (1988) 3
Prentis v. Atlantic Coast Line Co., 211 U.S. 210 (1908) 3
Yee v. Escondido, 112 S. Ct. 1522 (1992) 2

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REPLY BRIEF FOR PETITIONERS

The Commissioner opposes the petition on essentially two grounds. First, he argues that petitioners' facial challenge to the California Supreme Court's expressly announced confiscation standards is not ripe for this Court's current consideration. Br. in Opp. 7-9. Second, he argues that, in any event, the decision below does not warrant review, chiefly by suggesting that the decision does not actually rest on the rationale stated by the California Supreme Court. *Id.* at 10-17; *see also* 94-1119 Br. in Opp. 5-24. Neither argument bears scrutiny.

The first objection reflects a plain misunderstanding of ripeness law as it applies to the particular question presented for review. The second objection rests entirely on studied disregard of, and efforts to distract the Court from, the express rationale of the decision below. In fact, the case squarely and properly presents the entirely legal question whether the market-based cost-of-capital standard of *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), states a constitutional minimum for non-confiscatory rate regulation. Aside from the attempts to avoid that question, the Commissioner's briefs (in this case and in No. 94-1119) say nothing to dispute the obvious importance of this issue.

1. The Commissioner's primary argument against review of the facial takings challenge is that the question presented is not ripe for review. *See* Br. in Opp. 7-9.[1] But this argument is flatly inconsistent with this Court's clear holdings that the ripeness of a takings claim, as of any other type of legal claim, depends on the nature of the particular claim advanced. The Commissioner's ripeness objection, and the authorities cited in support, have no application to the question presented here, which does not ask this Court to resolve an as-applied claim of confiscation, but raises a purely legal issue wholly suitable for, and urgently demanding, immediate resolution.

Thus, in *Yee v. Escondido*, 112 S. Ct. 1522, 1531-32 (1992), the Court expressly distinguished as-applied takings claims from facial claims and held that a facial claim *was* ripe where that claim was neither hypothetical in character nor otherwise dependent for its resolution on facts insufficiently developed in the record, such as the extent of particular harm to a particular claimant. In so

[1] Notably, the Commissioner does not make any ripeness objection in No. 94-1119, which, in addition to an as-applied challenge, involves the same facial challenge to the Commissioner's regulations as does this petition. Nor did the Commissioner present a ripeness objection to the facial challenge in the California Supreme Court, which, of course, resolved this challenge on the merits.

holding, the Court followed prior rulings to the same effect. *See, e.g., Keystone Bituminous Coal Ass'n v. DeBenedictis*, 480 U.S. 470, 495 (1987); *Agins v. Tiburon*, 447 U.S. 255 (1980). None of the five decisions cited by the Commissioner on the ripeness issue says anything to the contrary.[2]

Here, the question raised by petitioners' facial challenge, and presented for review to this Court, is entirely legal and wholly fit for resolution in the current posture of this litigation. *See Pacific Gas & Elec. Co. v. State Energy Resources Conserv. & Dev. Comm'n*, 461 U.S. 190, 200-01 (1983) (ripeness standards). The California Supreme Court, applying the state-law requirement that rates be set no higher than the minimum level necessary to avoid confiscation, has declared that level to be lower than the *Hope* cost-of-capital standard.[3] The question pre-

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[2] Of the five cited decisions, four plainly involved no holding that a facial takings claim was unripe. *See Kaiser Aetna v. United States*, 444 U.S. 164 (1979) (adjudicating and finding a taking); *New Orleans Pub. Serv., Inc. v. Council of New Orleans*, 491 U.S. 350 (1989) (preemption, not takings, question at issue; holding that abstention was improper and claim should be adjudicated); *Prentis v. Atlantic Coast Line Co.*, 211 U.S. 210 (1908) (exhaustion of state non-judicial processes required for as-applied confiscation claim); *FPC v. Hope Natural Gas Co., supra* (adjudicating as-applied confiscation claim).

In *Pennell v. San Jose*, 485 U.S. 1, 9-11 (1988), the Court held that it would be "premature" for this Court to resolve a particular facial takings claim, but that holding was based on a circumstance not present here: the particular claim at issue challenged the authority of regulators to consider a particular factor (tenant hardship) in limiting permitted (rental) rates, yet there was no indication that the challenged factor ever had been, or in the future would be, actually relied on as a ground for limiting rates. (Justice Scalia, with Justice O'Connor, dissented as to ripeness and went on to find a taking.) The hypothetical character of the claim in *Pennell* has no counterpart here.

[3] The Commissioner's regulations state that rollback rates must be reduced to whatever level is minimally nonconfiscatory (or 80% of the 1987 rate if that is higher). *See* Pet. App. 20a-21a. The

sented—whether the state-law requirement of rates below the *Hope* standard is on its face inconsistent with the Takings Clause—does not turn on any facts about the requirement's impact on particular companies. It turns only on the legal standards required by *Hope* and the Fifth Amendment: that is, whether a law limiting companies to something less than the return specified by *Hope* is constitutional. That is why the California Supreme Court adjudicated the issue on the facial challenges presented in this "test case" (Pet. App. 34a), just as it had adjudicated the facial challenge to Proposition 103 in the earlier *Calfarm* case.

Not only is the issue fit for immediate resolution, but there is nothing remotely hypothetical about the impact of the standards adopted by the court below. Virtually all of petitioners already have been subjected to refund orders under those standards, in amounts totalling hundreds of millions of dollars. *See* Pet. 13 n.10.[4] There is nothing to be gained, and considerable resources in wasteful litigation to be lost, by postponing resolution of the purely legal question presented for this Court's decision on behalf of these parties who are directly affected by the state court's resolution of that question. The facial challenge in the two petitions for certiorari is fully ripe for decision along with 20th Century's as-applied challenge.

2. The Commissioner's remaining argument against review (Br. in Opp. 10-16; 94-1119 Br. in Opp. 5-24) rests on varied attempts to avoid the question presented. The most remarkable is the Commissioner's steadfast refusal in either of his briefs ever to quote or acknowledge the expressly stated rationale of the decision below. The

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California Supreme Court then construed the "minimally nonconfiscatory" standard, which has thus been incorporated as the state-law standard, *not* to require an opportunity to recover the firm's cost of capital. *See* Pet. 7-9.

[4] In addition to the refund orders noted at Pet. 13 n.10, we note that after the petition was filed, the FARMERS companies were ordered to pay $183 million in rollback-year refunds.

inescapable fact is that the California Supreme Court repeatedly stated, and repeatedly described as the key to its ruling, its view that Fifth Amendment confiscation standards do not entitle a regulated firm to earn a return based on the firm's cost of capital as defined in *Hope*. *See* Pet. App. 76a-85a, 112a-116a, 123a-124a; Pet. 7-9. The Commissioner's assiduous ignoring of the California Supreme Court's central holding betrays a telling embarrassment about its rationale.

Rather than face what the California Supreme Court said, the Commissioner advances his own interpretation of *Hope* and argues that the California Supreme Court did not reject that interpretation. Br. in Opp. 10-11; 94-1119 Br. in Opp. 9-14. But this response sidesteps the issue presented. The repeated holding of the California Supreme Court was, in terms, that the cost-of-capital standard set forth in *Hope* does not state a constitutional minimum. *See* Pet. App. 76a-85a, 112a-116a, 123a-124a; Pet. 7-9. That holding cannot be rewritten somehow to become an affirmation that *Hope*, construed in some other way, does state a constitutional minimum. Moreover, to the extent that the Commissioner suggests that the *Hope* cost-of-capital standard means something other than the "rate of return available in the marketplace on investments comparable in terms of risk and otherwise" (Pet. App. 30a), its construction differs not only from that of the California Supreme Court (just quoted) but from the accepted understanding of the decision as it is generally followed. *See*, *e.g.*, S. Breyer, *Regulation and Its Reform* 43 & n.20, 43-47 (1982); J. Bonbright, A. Danielsen, & D. Kamerschen, *Principles of Public Utility Rates* 316 (2d ed. 1988) (*Hope* establishes "opportunity cost principle," entitling investors to "expected return . . . equal to the returns they could expect on an investment of comparable risk elsewhere in the economy").[5] The

[5] There are various methods of approximating that expected market-based return. Virtually all state regulators set rates of

decision from which certiorari is here being sought rejects the *Hope* cost-of-capital standard as a constitutional minimum, and does so on the widely accepted understanding of that standard.

The Commissioner's other main strategy for trying to alleviate concern about the California Supreme Court's decision is to repeat the number "10 percent" pervasively in his briefs, as if incantation of a superficially reasonable-sounding return could, by itself, answer the legal question presented. But this strategy only highlights how unwilling the Commissioner is to come to grips with the basis of the California Supreme Court's decision. That decision squarely and openly rests on the repudiation of the *Hope* cost-of-capital standard as a constitutional entitlement, *not* on any conclusion that the *Hope* standard is *satisfied* by an end result of a 10% return. Indeed, the California Supreme Court rejected the confiscation claim of 20th Century after expressly accepting that its particular cost of capital was 20%. Pet. App. 116a.

The Commissioner's 10% figure is a red herring for a number of other reasons as well. Even as to 20th Century, the Commissioner still has not shown that the end result actually is a 10% return under the California Supreme Court's own method of calculating that result. To the contrary, amidst a confusing discussion of irrelevant matters (Br. in Opp. 12-14), the Commissioner conspicuously avoids ever disputing our simple showing that the state court's method in fact produces a return of roughly 8%—less than the Commissioner himself determined to be the constitutional minimum. Pet. 10 n.8. The same flaw in the Commissioner's reliance on the 10% figure applies more generally: the Commissioner's intimation of 10% as a general "end result" is quite simply

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return using some or all of those methods. *See, e.g.*, National Association of Regulatory Utility Commissioners, *Utility Regulatory Policy in the United States and Canada, Compilation 1993-1994* at 290, 463, 516, 546 (1994).

baseless. Rather, the 10% figure he repeatedly invokes is only the rate of return that is *plugged into* the formula, but *like the California Supreme Court*, the Commissioner has said nothing to show that the complex formula is calculated to *result* in a 10% rate of return.[6] Beyond that, the 10% figure would seem irrelevant under the Commissioner's own asserted view of the minimum constitutional standards: in his view, a 10% return meets constitutional standards "and then some" (94-1119 Br. in Opp. 16), and regulatory authorities' "orders that protect only out-of-pocket expenses—that leave *no profit* at all"—are constitutional (*id.* at 21 n.15).[7]

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[6] The California Supreme Court upheld the formula without disturbing the trial court's finding that the formula all but automatically produces a return less than the 10% figure plugged into it. *See* Pet. App. 177a n.20, 184a, 198a.

In fact, the California Supreme Court's method of calculating the end result produces *negative* rates of return for petitioners Century-National, FARMERS, FEDERAL, GREAT AMERICAN, and HOME (based on the Commissioner's refund orders, the recorded actual profits for 1989, and the federal income tax rate).

[7] Several other suggestions made by the Commissioner, each wholly immaterial to the actual rationale of the decision below, underscore the indefensibility of that decision. The Commissioner casually suggests that 20% (the figure for 20th Century not disputed by the California Supreme Court) seems a rather high return for regulated industries (94-1119 Br. in Opp. 8 n.5), as if rates of return could somehow be assessed independent of the riskiness of the particular business at issue. In fact, the market-required return for low-risk utilities operating in monopoly markets can hardly be expected to mirror the market-required return for riskier insurers operating in competitive markets. The Commissioner also asserts that "the question of confiscation is not even implicated where an enterprise is not required to participate in the regulated market" (*id.* at 8 n.6), but that proposition—advanced only by Justice Mosk in the California Supreme Court and, to put it mildly, highly controversial in general and as applied to insurers in California—was not the basis of the decision below. Similarly, the Commissioner briefly intimates that the rollback limit might be excused because it is only "a one-year limitation" (94-1119 Br. in Opp. 12 n.9), but the California Supreme Court, far from accepting,

In short, there is no legitimate ground for treating the rationale the California Supreme Court gave for its judgment as anything but the clear holding of the decision below. The California Supreme Court clearly rested its ruling on the conclusion that the *Hope* cost-of-capital standard does not state a constitutional minimum. As the Commissioner's vigorous avoidance of that rationale indicates, the California Supreme Court's decision demands review.

CONCLUSION

For the foregoing reasons, and for the reasons set forth previously, the petition for a writ of certiorari should be granted.

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seems to have rejected any such suggestion (Pet. App. 80a & n.19), which, indeed, is inconsistent with this Court's holding that a temporary taking is nonetheless a taking. *First English Evangelical Lutheran Church v. Los Angeles*, 482 U.S. 304 (1987).

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Nos. 94-1119 & 94-1120

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

20TH CENTURY INSURANCE CO., *et al.*,

Petitioners,

v.

CHARLES QUACKENBUSH, Insurance Commissioner of the State of California,

Respondent.

CENTURY-NATIONAL INSURANCE CO., *et al.*,

Petitioners,

v.

CHARLES QUACKENBUSH, Insurance Commissioner of the State of California,

Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of California

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RESPONDENT'S SUPPLEMENTAL BRIEF

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13pp

TABLE OF AUTHORITIES

CASES

ASARCO Inc. v. Kadish, 490 U.S. 605 (1989) 10

Aetna Life Ins. Co. v. Haworth,
300 U.S. 227 (1937) 5

American Nat'l Bank & Trust Co. v. Haroco, Inc., 473 U.S. 606 (1985) 6

Berkemer v. McCarthy, 468 U.S. 420 (1984) 6

Church of Scientology v. United States, ___ U.S. ___, 113 S. Ct. 447 (1992) 4

Duquesne Light Co. v. Barasch,
488 U.S. 299 (1989) 8

Federal Power Comm'n v. Hope Natural Gas Co.,
320 U.S. 591 (1944) 7, 9

Jersey Central Power & Light Co. v. F.E.R.C.,
810 F.2d 1168 (D.C. Cir. 1987) 8

Kaiser Aetna v. United States, 444 U.S. 164
(1979) 8

Karcher v. May, 484 U.S. 72 (1987) 5

Ex parte Leaf Tobacco Bd. of Trade,
222 U.S. 578 (1911) 5

Maryland Casualty Co. v. Pacific Co.,
312 U.S. 270 (1941) 5

Mills v. Green, 159 U.S. 651 (1895) 4

North Carolina v. Rice, 404 U.S. 244 (1971) 5

Stone v. Powell, 428 U.S. 465 (1976) 6

Yee v. City of Escondido, 503 U.S. ___, 112 S. Ct. 1522 (1992) 6, 8

RULES

Sup. Ct. R. 14.1(a) 2, 6

Sup. Ct. R. 15.7 1

Sup. Ct. R. 46.2 2

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of the State of California,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF CALIFORNIA

Pursuant to Supreme Court Rule 15.7, Respondent Charles Quackenbush, Insurance Commissioner of the State of California, submits this supplemental brief to advise the Court of a recent development that significantly affects consideration of the pending petitions for a writ of certiorari.

On January 25, 1995, subsequent to the filing of Respondent's Briefs in Opposition, Respondent Commissioner and Petitioners 20th Century Insurance Company and 21st Century Casualty Company (collectively "20th Century") entered into a stipulation resolving the litigation between the parties. Under the settlement, 20th Century has agreed to refund up to $78 million to its 1989 policyholders in full satisfaction of its rollback obligation under Proposition 103

and to withdraw its petition for certiorari before this Court. In accordance with the settlement terms, on January 30, 1995, 20th Century filed a Motion for Dismissal as Petitioner pursuant to Supreme Court Rule 46.2, and the company will begin the process of distributing the first $46 million in rollback checks within 45 days.

The Commissioner's settlement with 20th Century not only moots that insurer's challenge to the California Supreme Court's decision, but removes any ground for this Court to entertain the related petitions for certiorari filed by the other insurers in Nos. 94-1119 and 94-1120. As explained below, 20th Century was the only party with standing to seek certiorari review of the California court's ruling with respect to any as-applied challenge to the Commissioner's regulations or 20th Century's rollback order. The only portion of the decision below which survives 20th Century's withdrawal—a facial challenge to the constitutionality of the regulations' treatment of surplus—is neither "fairly included" within the question presented by these petitions, Sup. Ct. R. 14.1(a), nor remotely worthy of this Court's review. The petitions for a writ of certiorari should be denied.

1. The petitions for a writ of certiorari in No. 94-1119 and in No. 94-1120 both seek review of the decision of the California Supreme Court in *20th Century Insurance Co. v. Garamendi*, 8 Cal. 4th 216, 878 P.2d 566, 32 Cal. Rptr. 2d 807 (1994), upholding the constitutionality of 20th Century's rollback order and of the regulations adopted by the Commissioner to calculate the rollback rate. As noted in the California Supreme Court's opinion, (App. 3a-5a), that decision actually resolved appeals in three separate actions that had been consolidated in part by the Superior Court:

i. 20th Century Ins. Co., et al. v. Garamendi (San Francisco Superior Court No. 938470) ("*20th Century I*"), a complaint for declaratory and injunctive relief filed by 20th Century prior to any administrative adjudication of its rollback obligation, challenging the facial validity of the Commissioner's regulations on

various constitutional and state-law statutory grounds. (App. 3a-4a, 149a.)

ii. 20th Century Ins. Co., et al. v. Garamendi (Los Angeles Superior Court No. BS 016789) ("*20th Century II*"), a petition for writ of mandate filed by 20th Century seeking to set aside the Commissioner's order directing the company to refund to its policyholders $78 million, plus interest, and challenging the validity of various provisions of the Commissioner's regulations as applied to 20th Century in the rollback order. (App. 4a, 150a.)

iii. Hartford Steam Boiler Inspection & Ins. Co., et al. v. Garamendi (Los Angeles Superior Court No. BC023983) ("*Hartford Steam*"), a lawsuit filed by scores of insurers seeking initially to prevent Commissioner Garamendi from proceeding to adjudicate their rollback liability pursuant to his regulations and challenging the validity of those regulations on their face, including the generic determinations and the procedures by which the regulations were adopted. (App. 4a-5a, 147a, 150a.)

At the outset of the trial in the Superior Court, certain of the *Hartford Steam* plaintiffs moved to have their lawsuit consolidated with the *20th Century* litigation. (App. in Cal. S. Ct. at 3672-3775.) Both 20th Century and the Commissioner opposed consolidation, on the grounds that it would unduly complicate and broaden the scope of the *20th Century* case and that the *Hartford Steam* plaintiffs' claims were not ripe, none of them yet having completed an administrative hearing to determine their rollback liability under the Commissioner's regulations. (*See id.* at 3776-87, 3799-3876.)

After considering the matter at two separate hearings, the Superior Court ultimately decided to bifurcate the *Hartford Steam* action and to grant consolidation with respect to only one specific, limited issue: "Whether the Regulations and the Formula disregard a portion of insurers' capital and thereby deny them a fair and reasonable return ('the leverage

issue')." (*Id.* at 4789-90, 5075-82; *see* App. 4a, 150a.) The *Hartford Steam* plaintiffs (including the State Farm Petitioners in No. 94-1119 and the Century-National Petitioners in No. 94-1120) were allowed to file briefs and to participate in the *20th Century* case as amici curiae with respect to those issues not consolidated. (App. 150a.) The *Hartford Steam* parties appeared in that dual plaintiffs/amici status in the California Supreme Court, as well.[1]

2. 20th Century's settlement of its rollback obligation and withdrawal from further proceedings in this Court unquestionably render moot 20th Century's petition for a writ of certiorari in No. 94-1119. Clearly, there is no longer a case or controversy between 20th Century and the Commissioner. Beyond that, however, the settlement of 20th Century's rollback liability removes the basis for this Court's review of the as-applied issues raised by *any* of the petitions seeking review of the California Supreme Court's decision in the *20th Century* case.

It is a fundamental premise of federal jurisdiction that "a court has no authority 'to give opinions upon moot questions or abstract propositions, or to declare principles or rules of law which cannot affect the matter in issue in the case before it.'" *Church of Scientology v. United States*, ___ U.S. ___, 113 S. Ct. 447, 449 (1992) (quoting *Mills v. Green*, 159 U.S. 651, 653 (1895)). The Court's judgments must resolve "'a real and substantial controversy admitting of specific

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[1]Voter Revolt, the consumer-advocacy organization, and a single insurer, Allstate Insurance Company, both of which had participated as intervenors in 20th Century's administrative hearing, were granted leave to intervene in the *20th Century* case by the Superior Court. (App. 4a.) While the case was pending before the Supreme Court, however, Allstate reached a settlement with the Commissioner of its rollback obligation and was dismissed as a party to the proceeding. (App. 43a n.8; *see* Letter of Jan. 5, 1995 from Allstate counsel Marc Fairman to Hon. William K. Suter (advising that the Allstate companies are not parties to the Petition for Writ of Certiorari in No. 94-1119).)

relief through a decree of a conclusive character, as distinguished from an opinion advising what the law would be upon a hypothetical state of facts.'" *North Carolina v. Rice*, 404 U.S. 244, 246 (1971) (quoting *Aetna Life Ins. Co. v. Haworth*, 300 U.S. 227, 241 (1937)).

When presented to the California Supreme Court, and initially to this Court upon the petitions in Nos. 94-1119 and 94-1120, the insurers' legal arguments were advanced in the context of a concrete controversy between 20th Century and the Commissioner, involving a specific rollback order directed to that company. The controversy underlying the *20th Century* lawsuit has now been resolved, however, leaving the remaining insurers to seek from this Court precisely the "advisory opinion" that is proscribed by more than a century of established federal jurisprudence. Even the facial challenges to the Commissioner's rollback regulations subsumed in the *20th Century I* complaint have now been so divorced from any concrete set of facts that the case is lacking the "substantial controversy . . . of sufficient immediacy and reality to warrant the issuance of a declaratory judgment." *Maryland Casualty Co. v. Pacific Co.*, 312 U.S. 270, 273 (1941).

Moreover, none of the other insurers has standing to seek a writ of certiorari on the cost-of-capital question from the *20th Century* decision. As recounted above, the State Farm and Century-National Petitioners were never parties in the *20th Century* (as opposed to the *Hartford Steam*) case; they participated only as amici curiae in that case.[2] It is well established that "one who is not a party to a record and judgment is not entitled to appeal therefrom." *Ex parte Leaf Tobacco Bd. of Trade*, 222 U.S. 578, 581 (1911); *accord Karcher v. May*, 484 U.S. 72, 77 (1987). Since the remaining Petitioners in Nos. 94-1119 and 94-1120 were not parties

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[2]Indeed, the *Hartford Steam* plaintiffs' motion to intervene as parties in the *20th Century* case was expressly denied by the Superior Court, and no appeal was taken from that ruling. (App. in Cal. S. Ct. at 4638.)

to the *20th Century* case, they cannot independently pursue an appeal from those aspects of the California Supreme Court's decision relating only to 20th Century's claims, including its ruling on the cost of capital question presented in these two petitions for certiorari.

3. The State Farm and Century-National Petitioners were concededly parties to the *Hartford Steam* litigation, and they would be entitled to appeal from that portion of the California Supreme Court's decision addressing the one issue from the *Hartford Steam* case that had been consolidated with *20th Century*. But that issue—whether the Commissioner's regulations on their face deny insurers a fair rate of return by limiting the capital upon which the authorized return may be earned to the amount of surplus that is "used and useful" in their insurance operations—is neither properly presented nor worthy of this Court's certiorari review.

It has long been the Court's policy to limit its consideration to the questions presented for review in the petition for a writ of certiorari, or to those "subsidiary question[s] fairly included therein." Sup. Ct. R. 14.1(a). *See, e.g., Berkemer v. McCarthy*, 468 U.S. 420, 443 n.38 (1984); *Stone v. Powell*, 428 U.S. 465, 481 n.15 (1976) (rule to be disregarded "only in the most exceptional cases"). Only recently, in *Yee v. City of Escondido*, 503 U.S. ___, 112 S. Ct. 1522 (1992), the Court underscored the importance of that limitation to the integrity of the judicial function and to the efficient utilization of the Court's limited resources. 112 S. Ct. at 1532-33.

In this case, the "leverage" issue as framed by the *Hartford Steam* plaintiffs and considered by the courts below was not set forth in the petitions for certiorari in Nos. 94-1119 and 94-1120, nor can it be viewed as "fairly included therein." *See generally American Nat'l Bank & Trust Co. v. Haroco, Inc.*, 473 U.S. 606, 608 (1985). Both of those petitions seek review of a single aspect of the California Supreme Court's decision: whether a rate order denying an insurer its supposed cost of capital constitutes an unconstitu-

tional confiscation of its property.[3] None of the insurers has challenged the decision's ruling upholding the regulations' incorporation of imputed leverage factors. Although the two issues may in a sense be viewed as complementary,[4] the cost-of-capital question is theoretically and legally distinct from the surplus issue consolidated into the *20th Century* case, as evidenced by the California Supreme Court's discussion of the two points in separate sections of its opinion. (See App. 89a-90a, 100a-103a.) A fair reading of the petitions of both 20th Century and Century-National makes clear the theory Petitioners were urging: that the authorized rate of return was confiscatory because it was below 20th Century's claimed cost of capital. Without 20th Century's evidence that formed the basis of its (disputed) claim, there is no record of *any* insurer having a cost of capital higher than that specified in the regulations—and no record on which to reach the remaining insurers' rate-of-return argument.

Even if the petitions could be read to "fairly include[]" the leverage issue on which the remaining insurers were parties below, the lower court's decision on the leverage issue is wholly unworthy of this Court's certiorari review. Since this Court's decision in *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), it has been clear that regulators may define the capital base on which a return is authorized. Further, it is unquestionably appropri-

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[3]The Petitioners in 94-1120 do tender another, albeit wholly frivolous, issue: whether it would have been unconstitutional for the regulations to use non-jurisdictional income to offset jurisdictional losses. As explained in Respondent's Brief in Opposition in 94-1120, the regulations are expressly limited to each insurer's California business. (Resp't's Br. in Opp'n at 16-17.)

[4]As the California Supreme Court observed, "the leverage factor indirectly contributes to the setting of the rate itself by inverse relationship: the higher the leverage ratio, the smaller the used-and-useful capital and hence the smaller the rate; the lower the leverage ratio, the greater the used-and-useful capital and hence the greater the rate." (App. 100a.)

ate to limit that capital to an amount that is determined to be "used and useful" in rendering services to the public. *E.g.*, *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989); *Jersey Central Power & Light Co. v. F.E.R.C.*, 810 F.2d 1168, 1175 (D.C. Cir. 1987). Application of these accepted principles to the insurance business plainly authorizes the Commissioner to determine, through the use of leverage ratios, the amount of surplus that is actually called upon to support an insurer's operations, and upon which the insurer is therefore entitled to earn a return from its policyholders. As the opinion below recognized, "under-leverage (or overcapitalization) threatens undue profit: there is surplus beyond what is useful to back up premiums—surplus surplus—which inflates the insurer's capital base and any rate set thereon to the disadvantage of its insureds, while at the same time it produces investment income from appreciating assets." (App. 4a.)[5]

4. Finally, 20th Century's settlement and withdrawal of its challenge to the Commissioner's regulations and rollback order serve to underscore the lack of ripeness in the other insurers' petitions. At best, all that remains of this litigation is a facial challenge to some portion of the Commissioner's regulations. But as this Court has repeatedly emphasized, analysis of regulatory takings claims require "essentially ad hoc, factual inquiries," and they are thus uniquely unsuited to facial challenges. *E.g.*, *Yee v. City of Escondido*, 503 U.S. at ___, 112 S. Ct. at 1529; *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979). That is especially so in

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[5]To be sure, the non-recognition of a portion of an insurer's surplus may, "[a]t the margins, . . . have constitutional overtones," *Duquesne Light Co.*, 488 U.S. at 310, but a claim to that effect could scarcely be resolved in a facial challenge, such as presented by these Petitioners. That is particularly so in this case, because—as the California Supreme Court emphasized—the return an insurer is denied on the nonrecognized surplus is offset by the regulations' failure to include in the ratemaking formula the investment income realized by the insurer on that same excluded surplus. (App. 73a-74a, 101a.)

reviewing the constitutionality of rate orders, where "[i]t is not theory, but the impact of the rate order which counts." *Hope Natural Gas*, 320 U.S. at 602. Yet with 20th Century's settlement of its rollback, the State Farm and Century-National Petitioners are left with no "impact" to complain about, only the "theory" to be employed in arriving at a future result.

On their face, the Commissioner's regulations cannot be said to be confiscatory, for they explicitly guarantee an insurer a "minimum nonconfiscatory rate," and provide for variances as the final mechanism for rate adjustments necessary to avoid confiscation. (App. 24a, 84a-85a, 102a.) Without any record showing the "end result" of the regulations' operation on them, the remaining Petitioners likewise cannot possibly hope to prove confiscation as applied.[6] Indeed, given that the Commissioner's regulations govern a one-time event and that many insurers have now resolved their rollback liability through settlements, it is doubtful whether the question presented in these petitions will ever even arise again, much less on the record of an insurer claiming a constitutional entitlement to a cost-of-capital of more than 20%, double the industry-average 10% rate of return. (App. 27a.)

The case these Petitioners sought to bring to this Court was a rate order to 20th Century, yielding an end-result of a 10% return on equity for one year. Petitioners' claim was that the 10% profit was confiscatory in the face of evidence that they claimed showed the company to have a cost of capital in excess of 20%. 20th Century is now gone, and

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[6]Petitioners lack not only a record of how the regulations would be applied, they also lack a record of how the regulations were adopted. The extensive rulemaking file compiled in the process of adopting the regulations is not a part of the record below. Thus, Petitioners would have this Court conduct a facial review of the regulations without the record containing the public's comments on the regulations and the agency's statement of reasons for their adoption.

with it any arguable evidentiary claim about any firm's cost of capital and end result. Under these circumstances, there is no basis for the Court to entertain the petitions for writ of certiorari. The petitions should be denied and the judgment of the California Supreme Court left undisturbed. *See ASARCO Inc. v. Kadish*, 490 U.S. 605, 621 n.1 (1989).

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On Petition for a Writ of Certiorari to the Supreme Court of California

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SUPPLEMENTAL BRIEF OF PETITIONERS IN RESPONSE TO RESPONDENT'S SUPPLEMENTAL BRIEF

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SUPPLEMENTAL BRIEF OF PETITIONERS IN RESPONSE TO RESPONDENT'S SUPPLEMENTAL BRIEF

The Commissioner's supplemental brief raises one new argument that warrants a response.[1] The Commissioner argues that petitioners were only *amici*, and not parties, in the California Supreme Court with respect to all issues

[1] The Commissioner also repeats his earlier argument about the appropriateness of this Court's consideration of the facial constitutionality issue presented to this Court, but that argument was fully answered in our Reply Brief.

decided by that court except for the "leverage issue." For that reason, the Commissioner contends, even though petitioners' refund liability (amounting to hundreds of millions of dollars) will unavoidably be governed by the California Supreme Court's confiscation standards, petitioners lack standing to seek review of those standards, no matter how much the decision below otherwise warrants this Court's review and reversal.

As an initial matter, however, the Commissioner's new argument violates this Court's Rules. The argument is in no way based on or dependent on 20th Century's recent settlement, the sole excuse cited by the Commissioner for his supplemental filing; indeed, 20th Century is not even one of the present petitioners (No. 94-1120). This contention, if it had merit, was fully available to the Commissioner to make in his brief in opposition, yet he made no such argument there. Accordingly, the supplemental brief is in direct violation of this Court's Rule 15.7, which states that "[a] supplemental brief must be restricted to new matter," that is, "to new cases or legislation or other intervening matter not available at the time of the party's last filing." The brief should be disallowed.

In any event, as the late timing itself indicates, the Commissioner's last-minute effort to avoid review of the decision below is wrong. The contention mischaracterizes the role of petitioners in the judgment below. As a formal as well as practical matter, petitioners—as part of the Hartford Steam Boiler group below—were parties, not merely *amici,* to the California Supreme Court's judgment on all of the facial-constitutionality issues, not just on the leverage issue.

Thus, beginning in the Superior Court, the Hartford Steam insurers participated fully on *all* of the facial-validity issues as *parties,* both in briefs and argument, even being allowed to introduce evidence going to issues other than the leverage issue. *See* Nov. 30, 1992 Tr. 16, 23. The Superior Court held the Commissioner's regula-

tions invalid on their face. The court framed its order and judgment without in any way dividing up issues party by party or otherwise limiting the reach of the judgment with respect to the Hartford Steam group, including petitioners. Pet. App. 212a-213a; *see also* Judgment dated March 22, 1993.

The Commissioner appealed from the Superior Court decision, and the Hartford Steam group *cross-appealed. See* Pet. App. 42a. Since petitioners prevailed on the leverage issue in the Superior Court (Pet. App. 205a), the cross-appeal necessarily involved other facial-validity issues, including the cost-of-capital argument based on *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), that petitioners now raise in this Court, an argument on which petitioners did not fully prevail in the Superior Court (*see* Pet. App. 177a-195a). The Hartford Steam group expressly spelled out the *Hope* issue in filing, as a party, its Answer to Petitions for Transfer in the California Supreme Court. The California Supreme Court then took jurisdiction over and expressly decided all of the appeals *and cross-appeals* before it. Pet. App. 3a, 42a. Contrary to the Commissioner's new position, therefore, the California Supreme Court's judgment with respect to petitioners could not have been and was not limited to the leverage issue.

Indeed, at no point did the Commissioner ever suggest, or the California Supreme Court rule or even intimate, that the Hartford Steam group's cross-appeal—which, as noted, could not have involved the leverage issue—was not properly before the California Supreme Court. Nor did the Commissioner ever contest the propriety of the Hartford Steam group's full participation as a party, in briefs and argument, on *all* of the facial-invalidity issues. Not surprisingly, then, the California Supreme Court rendered a single judgment that in no way divided up issues party by party. Pet. App. 128a ("For the reasons stated above, we conclude that we must reverse the judgment

of the superior court and direct that court to render judgment in favor of the Insurance Commissioner and Voter Revolt and against 20th Century, Hartford, State Farm, et al.").

Given these circumstances, it is no mystery that the Commissioner did not think to dispute petitioners' party status on the *Hope* issue when he filed his brief in opposition. In technical as well as real terms, petitioners plainly are subject to the California Supreme Court's judgment declaring the cost-of-capital standard of *Hope Natural Gas* not to state a constitutional minimum. The Commissioner's "standing" objection—presented in violation of Sup. Ct. R. 15.7 in a last-ditch effort to wear down petitioners through unnecessary delay of review—should be rejected.[2]

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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[2] At a minimum, any residual uncertainty on the question of petitioners' party status should not be a ground for denying the petition without a remand for the Commissioner to present his contention about party status to the California Supreme Court.